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THE DOLLAR AND THE EXCHANGE RATE SYSTEM

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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THE DOLLAR AND THE EXCHANGE RATE SYSTEM

FRIDAY, FEBRUARY 21, 1986

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC GOALS
AND INTERGOVERNMENTAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the subcommittee) presiding.

Present: Representative Hamilton and Senator D'Amato.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. Well, good morning, everyone. We'll get underway. The meeting of the subcommittee will come to order.

The value of the operation and the operations in the exchange rate system used to be of very little interest to the Congress or to the American people. No longer.

Our mounting trade deficit, with the attendant pain of lost jobs and impaired competitiveness, largely a function of an overvalued dollar, has brought home to the Congress how important a properly functioning exchange rate system is to economic prosperity and opportunity in the United States.

One only needs to take a look at the major omnibus trade bills being considered in the Congress this session to know that exchange rates are now front and center in the current debate on how we improve our economic performance.

President Reagan recognized as much in his State of the Union Address, where he asked the Treasury Department to examine whether there ought to be a new international monetary conference to reform the existing exchange rate system.

So I've asked this group of very eminent economists to join us today to—Senator, how are you? Join us today to discuss the issue of exchange rate reform.

I've chosen the format of a roundtable in lieu of a hearing because I believe that the give and take among informed individuals will be of most value to us in this circumstance. I hope each of you will be brief in your opening remarks so that we can leave ample time for discussion.

The Chair wants to focus on the issues that he raised in his letter to you, letters of invitation to you. Those questions are:

Do we need a new exchange rate system?

Is the present system working? If it's not, what's wrong with it?

Would a system based on target zones be better? If so, why? How would it work?

The second question relates to macroeconomic policy coordination among the key currency countries:

Is it possible? Is it desirable?

The third question is:

Absent more fundamental reform, should our monetary policy be more exchange rate oriented?

And the final question is:

Does the dollar need to fall further? And, if so, what are the implications of that and at what cost?

Is the dollar approaching a danger zone, as the Chairman of the Federal Reserve said to the Congress yesterday?

We've asked each of you to focus on a particular aspect of this question in your opening statement. What I'd hope we can do is, after you complete your preliminary statements, I want to encourage you to comment on the statements of your colleagues, what you find in those statements to be correct, and those things with which you might have some disagreement.

So we will begin. And Mr. de Vries has asked to be last, as I understand it, in order of testimony. I don't think it makes much difference otherwise. Mr. Krugman, I'll begin with you, and then Mr. Dornbusch, Mr. Cooper, and Mr. Branson, if he appears, and then Mr. de Vries.

Senator D'Amato. Mr. Chairman.

Representative Hamilton. Senator D'Amato, excuse me.

Senator D'Amato. OK. I'm sorry, Mr. Chairman, that I'm not going to be able to stay for the hearing, because I have a Defense subcommittee hearing which is being held at the present time. For the life of me, I wonder why we do these things to ourselves.

But, we do. We find ourselves on maybe six or seven different committees, and dozens of subcommittees, racing around. I'm going to ask if I might be able to submit a written opening statement for the record.

Representative Hamilton. Certainly.

[The written opening statement of Senator D'Amato follows:]

Written Opening Statement of Senator D'Amato

Good morning, Mr. Chairman, I would like to commend you for conducting this important and timely hearing. Before we begin, I would like to welcome Rudiger Krugman from MIT; Richard Cooper from Harvard University; Morgan de Vries of Morgan Guaranty; and William Branson of Princeton University. I would like to thank these gentlemen for taking time from their busy schedules to testify before the committee today. I believe hearings such as these provide the information needed as to educate the public on how the exchange system actually works.

The dollar has been steadily falling since hitting record highs against most major currencies about a year ago. One of the major factors for this downward trend was initiated through a concerted effort by five Western industrial nations, including the United States, to lower the dollar's value in an attempt to close the U.S. trade deficit. I agree with this effort. I believe that by providing a lower currency value, U.S. products will be less expensive to foreign buyers and our exports will rise. By creating a weaker dollar, the price of imported products rises, making them less appealing to American consumers. This process should have the effect of closing the trade deficit.

The value of the dollar and the exchange rate system are vital in controlling the trade deficit. Gentlemen, I am interested in hearing your views on this topic.
Thank you, Mr. Chairman.

Senator D'AMATO. I certainly look forward to reading the testimony of our distinguished witnesses.

Chairman Volcker, yesterday, testifying before the Banking Committee in the Senate, left this Senator rather confused in light of the fact of what might appear to be some contradictory statements coming out of Treasury, and others, who say they're looking forward to the dollar coming down even further. Mr. Volcker's admonition was that this possibly could create some difficulties.

I think that's a very real question, as the chairman has raised, and I think it would be of some interest if you might comment.

Who was to determine, and this was another question which was raised, what the proper value is?

I wonder. How do we establish that?

Then, if you're talking simply about trade and trade balances, how do we create a climate in which we can be more competitive?

Don't we really have to take into account other kinds of things that affect trade as well? That is, the policy of various governments must be taken into account, notwithstanding their good intentions and their wonderful platitudes, such as the Japanese. As far as this Senator is concerned, they have set up a very intriguing system of market penetration and market protection.

So as long as you have those kinds of situations, I wonder whether or not the value of the dollar coming down is going to be all so important in terms of the trade balancing.

There are a number of those very interesting questions, and I hope the roundtable discussion that is going to be ongoing today with the chairman will produce some additional insights into this area. Although I won't be able to partake, I certainly am going to be interested in reading the record.

Thank you, Mr. Chairman.

Representative HAMILTON. Senator, thank you very much for joining us, even briefly, this morning. We're pleased to have you. And, of course, your statement will be entered into the record in full. Mr. Krugman, please proceed.

STATEMENT OF PAUL KRUGMAN, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. KRUGMAN. Thank you. It's not Passover yet, but I would like to put my remarks in the form of five questions and their answers.

The first question is, has the dollar fallen enough to restore U.S. competitiveness?

The answer is no. We have substantially improved on the disastrous U.S. competitive position of a year ago. But if you evaluate the facts carefully, you find that we're still well short of restoring a satisfactory U.S. competitive position. The current position is still not comparable to that which existed at the end of the 1970's.

The second question is, should the Federal Reserve be attempting to drive the dollar down further through monetary policy, through interest rate reductions in particular?

My answer to that, which I expect will be controversial, is no, that an attempt to push the dollar down further through monetary policy alone would run substantial inflation risk from both the demand side and the supply side.

I'll argue in a minute that it would be dangerous even to say that the Federal Reserve should commit itself to holding the dollar at its current level.

Third question, is reducing the budget deficit still crucial to restoring U.S. competitiveness?

Economists have been calling for deficit reduction and arguing for a link between the budget deficit and the trade deficit for some time. Does the recent fall in the dollar contradict that presumed relationship?

The answer is that despite its recent fall, the dollar can't be counted on to go the rest of the way down to restore competitiveness without deficit reduction. And, in fact, if we don't get substantial deficit reductions, I would argue that we'll find that the dollar's decline has overshot and that the dollar will rebound at least part of the way.

Fourth question:

Aside from getting the deficit under control, do we need more active exchange rate management than we had until a few months ago?

My answer is that yes, we do. Experience of the last 2 years demonstrates to my satisfaction, at any rate, that the foreign exchange market is subject to large and, in some respects, dangerous, speculative bubbles. The runup of the dollar from mid-1984 to early 1985 is the prime example. Government policy can and should act to burst these bubbles when they're getting out of hand.

The last question is, does this mean that we should be looking for a return to something like fixed exchange rates?

My answer to that is no; although we have evidence now that speculative bubbles have been a source of large exchange rate swings, they are not the only source of exchange rate movements.

The international capital flows, which were the source of the sustained strength of the dollar in the first half of the 1980's, were not primarily due to any kind of speculative bubble; they were due to fundamental forces, mostly forces arising from U.S. tax cuts.

In fact, although we've had a rocky road, we've coped with those massive capital flows relatively smoothly, considering the size of the disruption over the past 5 years.

If we had had a fixed rate system over that same period, those same capital flows, which I would argue would still have happened, would have created massive inflationary pressure in the United States, massive deflationary pressure in other countries, this would, in the end, have been worse than what we experienced.

I believe that if we had somehow managed to start with a fixed rate system in 1980, that system would have collapsed by now. And the collapse would have been messy, would have left us worse off than we are now.

And I also believe that if we were to try to go to a fixed rate system now or some time in the near future, that system, in turn, would collapse within a few years.

I've have simply asserted my answers to these questions. I assume that, in the course of the discussion and in the course of the argumentation, I'll get a chance to justify them a bit further.

Thank you.

Representative HAMILTON. Good. That's a good start.

Would you mind running over your second question for me? What was it?

Mr. KRUGMAN. Should the Federal Reserve attempt to drive the dollar down further now by cutting interest rates?

And the answer was no.

Representative HAMILTON. OK. Very good.

[The prepared statement of Mr. Krugman follows:]

PREPARED STATEMENT OF PAUL KRUGMAN

INTERNATIONAL MONETARY ISSUES

Calls for international monetary reform derive their urgency from the drastic deterioration in US competitiveness since 1980. The essential fact is that the US has gone from current account surpluses in 1980 and 1981 to a deficit of about 130 billion dollars in 1985. To think about this sensibly, we need to answer five questions:

1. Why has the US trade balance worsened so much? The brief answer is 60% the strong dollar, 20% the failure of other industrial countries to recover from the 1980-82 recession, 20% the international debt crisis. The point is that the exchange rate is the biggest though not the sole cause of the problem. The decline in the dollar over the past year will help, but is not enough to restore US competitiveness.

2. Why is the dollar so strong? The sustained strength of the dollar since 1981 is best explained by the US budget deficit and, to a lesser degree, strong investment demand in the US. Shorter term fluctuations in the exchange rate seem, however, to have represented speculative bubbles; in particular, the sharp rise in the dollar from mid-1984 to February 1985, and its subsequent decline, was probably a bubble that burst.

3. <u>What are the consequences of the strong dollar?</u> Some groups are hurt by the strong dollar, and the risks of a protectionist reaction are high. Most Americans have, however, benefited from the strong dollar. The problem is that this cannot last, and that the US is in effect living beyond its means. When the reckoning comes, the US will risk a severe inflationary shock, which will be worse the longer it is delayed.

4. <u>What should our immediate policy be?</u> No matter what other policies we undertake, the trade problem cannot be resolved without sharply reducing the budget deficit. We have to be careful about the method of deficit reduction, however. A shift to indirect taxation, such as a VAT or its disguised equivalent, will compound the inflationary shock of a falling dollar.

5. <u>How should we change the international monetary system?</u> The size of speculative movements in exchange rates shows that complete free floating needs to be restricted by at least occasional exchange rate management. A return to fixed rates or worse still a gold standard would, however, probably not be feasible and would not be desirable even if it were.

In the remainder of this paper I will expand on these answers and their justifications.

SOURCES OF THE TRADE DEFICIT

One of the most carefully carried out breakdowns of the sources of the trade deficit was provided in the 1984 Economic Report of the President. That analysis found that about 50 percent of the then-projected 1984 current account deficit could be attributed to the exchange rate; about 30 percent to the fall in exports to developing countries resulting from the debt crisis; and about 20 percent to a faster recovery in the US than in other industrial countries. An adjustment of these numbers to reflect what has happened since leads us to a breakdown more like 60-20-20. (The US recovered faster than expected in 1984; however, the further deterioration in 1985 represented lagged exchange rate effects). The point that the exchange rate played the major but not exclusive role is confirmed by all econometric estimates I have seen.

The main source of confusion now is whether the decline in the dollar over the past year has solved the overvaluation problem. The decline in the dollar has certainly been steep: 25 percent against the mark and 27 percent against the yen. However, the belief that we have now got the dollar down far enough is not at all correct, for three reasons.

First, against European currencies the fall in the dollar has only partly reversed its huge rise since 1980. This is illustrated in the left side of the accompanying chart, which compares the real rise of the dollar against the mark (adjusted for differences in consumer price inflation) from 1980 to a year ago with its subsequent fall. The dollar decline over the past year has reversed only 43 percent of its previous rise.

Japan presents a different picture. As the right side of the chart shows, the recent rise in the yen has offset its earlier fall, leaving the real dollar-yen rate just about at its 1980 level. To say that this solves the exchange rate problem, however, is to overlook the importance of structural change. Because Japan's rapid productivity growth is concentrated in those sectors that compete internationally, and is much slower in services and other nontraded products, any real exchange rate measure using overall domestic prices becomes increasingly misleading over time. Recent estimates by Richard Marston suggest that this bias amounts to about 4 percent a year: that is, to keep US and Japanese relative costs in internationally competitive sectors on an even keel, the yen would have had to appreciate by about 20 percent in real terms since 1980. Equivalently, we can say that to restore the competitive position of 1980 the yen would have to rise to something like 160-165 to the dollar.

Finally, all evidence shows that trade responds to exchange rates with a substantial lag. This is important because the spectacular fall of the dollar since February 1985 follows on the heels of an only slightly less spectacular rise from mid-1984 to last February. This rise had not had time to be reflected in the 1985 trade balance, so most of the effect of the subsequent decline will be simply to keep the trade balance from getting worse instead of leading it to become better.

THE SOURCES OF THE STRONG DOLLAR

This paper is not the place to recapitulate the debate over the causes of the strong dollar. The basic point is that economic theory tells us that a budget deficit should attract capital inflows and bid up the value of the dollar, and that is what happened. Tax incentives for investment should do the same thing, and the strength of US investment despite high real interest rates is evidence for a role for this factor as well. The sustained strength of the dollar since 1981, as compared with the previous period, is best explained by the budget deficit with a little help from ACRS.

Fluctuations of the dollar *within* this period -- and particularly the soaring dollar of late 1984 and early 1985 -- cannot be explained in this way. There was no new information available to the market that seems to explain why the dollar rose so sharply. Furthermore, the level of the dollar at its peak seemed clearly unreasonable. US interest rates were only moderately above those in other industrial countries, implying that those who were investing in the US believed that the dollar would decline only slowly. Yet a dollar decline slow enough to validate this belief would have implied enormous, persistent US trade deficits. Eventually the US would have had to borrow so much from abroad that it would have become a debtor to a degree at least as great as Brazil and Mexico.

My belief was at that time and still is that what was happening was a speculative bubble, in which players on the exchange market became preoccupied with the short run and failed to ask whether the exchange rate made any long run sense. This has two implications. First, it means that much of the success we have had in driving the dollar down is a once-for-all exercise in bubblebursting. When a similar calculation is done for the current real exchange rate, the implied debt accumulation is less than a third as large, so that the current level no longer appears to imply inconsistent market expectations. Up to a point, then, the dollar could be driven down without any fundamental change in policy; from here on in, we are unlikely to be able to get much of a further fall without real action.

The other implication is that the view that we can always trust the market to produce a stable exchange rate as long as monetary and fiscal policies are stable is not borne out by experience. Contrary to what some economists have asserted, speculative runs can be an independent source of exchange rate fluctuations.

THE COSTS OF THE STRONG DOLLAR

Obviously the strong dollar hurts firms and workers who face international competition and are not effectively protected by import quotas: probably exporters, including especially farmers, are the main losers. By undermining the traditional support of exporters for free trade, the strong dollar has threatened a surge of protectionism that could irreversibly damage the international economic system.

For most Americans, however, the trade deficit has been a good thing -- so far. Capital inflows have allowed us to cut taxes without either raising savings rates or crowding out investment. At the same time, the strong dollar has raised the real incomes of most Americans by holding down import prices.

The problem of course is that this is not a sustainable situation. The nonfarm US economy is currently living about 6 percent beyond its means: borrowing about 3 percent of its income from abroad each year, and experiencing temporarily favorable terms of trade due to the strong dollar that contribute about another 3 percent. In effect, the US is using credit to buy goods on a sale that won't last.

When the capital inflows end, as they eventually must, the problem will then be how to manage a 6 percent cutback in real spending. This is the same problem that Latin American debtors have faced, and on a not much smaller scale (Brazil and Mexico both faced forced spending cutbacks of about 8 percent, those these initial cutbacks have been compounded by recession).

A bad scenario, which is unfortunately easy to imagine, is as follows: the US finally brings its budget deficit under control with new taxes along the lines of the Value Added Tax. The new VAT, whatever its name, would amount to a sales tax at a rate of 3-4 percent on average across all goods. Fiscal reform would at the same time lead to a fall in the dollar, adding another 3 percent directly to prices. So we can envisage a supply-side shock from tax increases and a declining dollar that would add 6 percent or more to the price level; this is a shock as big as the two oil price shocks, and it could lead to a wage-price spiral that drives inflation once again to levels not seen since 1981. The Federal Reserve would surely try to curb this inflation, leading to a recession of the same order of magnitude as 1974-5 and 1980-82.

The important point, however, is that the cutback in real spending cannot be avoided, only postponed. And the longer it is postponed, the larger it will have to be, both because of growing US debt (foreign and domestic) and because competiveness gets harder to regain the longer it has been lost.

POLICY FOR THE NEAR FUTURE

Whatever reforms of the international monetary system we may contemplate, a precondition for lasting improvement in the US position is elimination of most of the budget deficit. Ideally this could be done by eliminating waste and fat; realistically, in the end what will happen is a tax increase. For the reasons described above, the sooner this happens the better.

We have to be careful about the form of tax increase, however. A new tax that adds directly to prices, such as a VAT (even if disguised as a business transfer tax) or an oil import levy will add to inflation at the same time that a falling dollar is giving a large inflationary shock. A combination of indirect tax increases, dollar decline, and (say) a reversal of our good luck on commodity prices could have disastrous consequences.

This means that at least at first tax increases should come in the form of direct taxes. There is a good long-run case for shifting to indirect taxes as a way to encourage saving, but this should be done gradually. For example, we could impose a temporary income tax surcharge that is phased out as a VAT comes on line over 4-5 years.

REFORMING THE INTERNATIONAL MONETARY SYSTEM

The events of the last two years show that a laissez-faire attitude toward the exchange rate cannot be justified. The runup of the dollar in 1984-5 appears to have been a speculative bubble, yet it strained the politics of trade almost to breaking point. We need to be alert to the possibility of such bubbles, and to be willing both to intervene in the markets and if necessary to alter monetary policy to burst them when they happen. In other words, a return to "managed" floating as opposed to entirely free floating is a good idea. Managing the floating will be most successful if it is backed by both coordinated intervention and a more general coordination of macroeconomic policies.

What about a return to fixed rates? The important point here is that in addition to speculative bubbles, there have been more fundamental forces causing capital flows to the US: the budget deficit and US investment demand. Fixed rates would have had to cope with these same forces. Suppose, as is likely, that the same huge capital inflows that have kept the dollar strong would have occurred with fixed exchange rates. How would this have turned out?

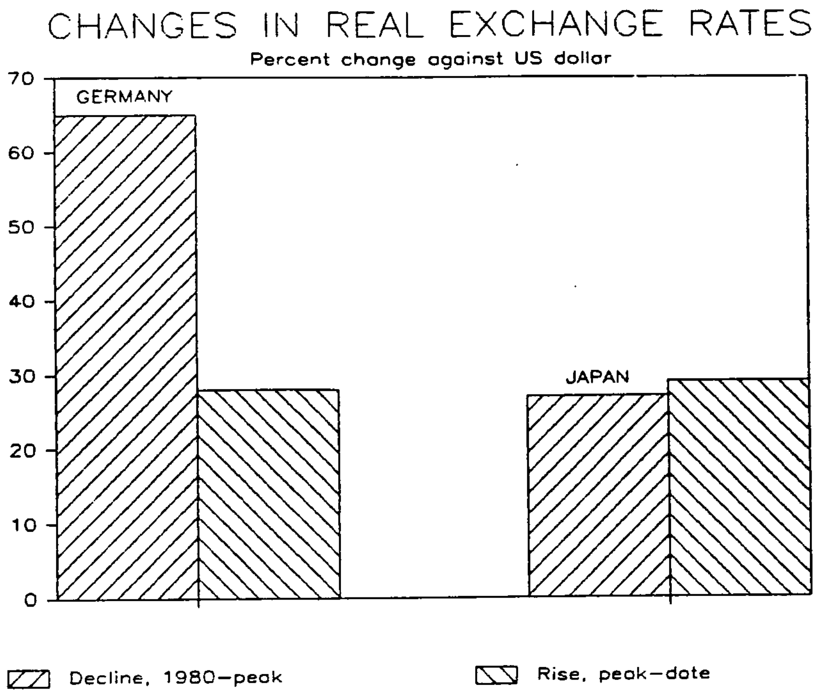
The answer is that the result would probably have been even worse than what has happened. Unrestricted capital inflows would have led to huge money supply increases and accelerating inflation in the US, sharp monetary contraction and deflation elsewhere. The consequences would have been so extreme that the system would almost surely have broken apart. Either fixed rates would have been abandoned, as they were in the face of much smaller capital flows in 1973, or fixed rates would have been preserved at the cost of extensive exchange controls.

Suppose that we were to try to go over to fixed rates now. Then the problem would be one of synchronizing the change with the end of US budget deficits. If we set the dollar at its current level, the result when the deficit is reduced will be to require massive US deflation; if we set the dollar at its long run level before getting the budget under control, the result will be immediate massive inflation. If we somehow make it through the transition, we are only clear until the next massive shock hits.

The only justification for believing that fixed rates could have avoided the problems of the last five years is the argument that the fundamentals of budgets and investment demand would have been very different. It seems clear to me, however, that the Reagan Revolution would have proceeded whatever the international monetary system.

Finally, we should note that a gold standard has all the problems of fixed rates, plus the additional problem of worldwide inflationary or deflationary pressure if the real price of gold is not set exactly right.

The bottom line then is that a fundamental reform of the international monetary system still does not look like a good idea. Speculative bubbles can be dealt with without massive reform, although more cooperation would help greatly. Otherwise, floating rates have actually served us rather well. The basic source of international monetary problems has been massively irresponsible policies, in the US and Germany in particular. Under floating rates these have done less harm than they might have.


CHANGES IN REAL EXCHANGE RATES
Percent change against US dollar
70
60
50
40
30
20
10
0
GERMANY
JAPAN
Decline, 1980–peak
Rise, peak–date

Representative HAMILTON. Please proceed, Mr. Dornbusch.

STATEMENT OF RUDIGER DORNBUSCH, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. DORNBUSCH. On very much the same point, I want to address three issues. The dollar: Do we need a further decline? Should we seek it actively?

The second issue, interest rates in the world economy.

And the third, should we try target zones?

My view is that the dollar does not really need to go down further. That interest rate reduction in the world economy is very important and should be a priority for U.S. policy. And that target zones are undesirable in the absence of coordination of fiscal policies, interest rate policies, and monetary policies.

The decline of the dollar, my argument here is that if we look at trade equations for the United States, we find that the external balance is well explained by activity here and abroad, the real exchange rate and oil prices.

If we look at the values that were achieved at the end of last year, allowing for the lags with which the trade balance adjusts, we would come down from 2.5 percent of GNP deficit in the external balance to about 1, perhaps somewhat more, by 1988.

The question is, what happens with the remaining 1? Is it very urgent that we should drive down the dollar to get rid of that, too? The balance of costs and benefits there suggesting that we should be cagey.

And two arguments, I think, are relevant. The first is that dollar depreciation is significantly inflationary and that we want to bear that in mind because the inflation that we would create would force tight money, which would shift the burden to other sectors of the economy.

The other is that declining oil prices, which now are a real possibility, and higher growth abroad, can easily look after the remaining percent.

So I do think that the oil price and growth abroad should look after the remaining adjustment, and a lot of it is in the pipeline from the dollar decline that has occurred.

On interest rates, I note, if you look in my prepared statement at table 2, that real interest rates are exceptionally high. The average of the real T-bill rate—adjusted for inflation—between 1927 and 1970 was zero. By comparison, we have now real interest rates in industrialized countries of 4, 5, or 6 percent, and they have been high for a very long period of time.

In the course of budget correction, we need a shift in the monetary fiscal mix toward much lower interest rates, as much as 2 percentage points. But the United States can't encourage that interest rate reduction because the dollar would precipitously fall; it would be very inflationary.

So the argument is that we need a world reduction in interest rates. Abroad, a reduction in interest rates, if anything, is more appropriate than in the United States.

Europe has record-high unemployment. Japan has caused the yen to go up with tight money without offsetting fiscal stimulus. So this is the right policy for the world economy.

The only possible objection is inflation. I point out in my prepared statement that in major industrialized countries, wholesale prices are actually falling. They aren't rising, they're falling.

In the United States, the last 3 months, by 1 percent. In Germany, they're falling. In Japan, by 10 percent. So in this deflationary environment there is no significant inflation risk of joint world reduction interest rates.

The puzzle is: Why hasn't it been happening? We can see that the Japanese didn't do it because our trade policy threats mean that they have to have a strong yen for the time being.

But, the big question is why Europe didn't do it?

The last point is the target zone issue. And, there, I see three issues. The first is volatility. There's a common view that anything that moves a lot moves too much and one should go in and fix it.

But if we look at major economic variables, prices of long-term bonds or the stock market, they certainly move more than the exchange rate. They have at least as important effects on the economy, and very few people would be enthusiastic about using monetary policy to fix the real value of the stock market, or to fix the real interest rate.

We have to be very careful when we believe that, in the exchange market, we can and should do something which we wouldn't do in the stock market and in the bond market where exactly the same irrational speculators put prices on assets that we can't understand, and where the volatility is much, much larger than even the extreme volatility of exchange rates.

The second argument is instruments. I draw attention in my prepared statement to the shift in fiscal policies in Europe, in Japan, and in the United States. We always talk of our deficit as the reason for the shift in the dollar. But, of course, they have moved abroad in the opposite direction by roughly the same amount.

That's the largest recorded fiscal shift in history. That's easy to assert because we don't have data for more than 40 years. But we must not be surprised if exchange rates move in a fantastic way when we get as sudden and large fiscal shifts both here and abroad.

Now, if we were to fix the exchange rates in the face of those large fiscal shifts, what we would have to do in fact is monetize deficits. The very last thing we should do is, when we have reckless fiscal policy, make monetary policy also go wrong simply to have a fixed exchange rate.

Coordination of monetary and fiscal policies would be the minimum premise for target zones. There is no indication that fiscal coordination is something this Congress would do, the French Congress or any Congress. If one reads the latest French proposal that just has surfaced, there is in fact no mention of fiscal policy.

There is mention that the Federal Reserve is not willing to make the exchange rate the primary target of monetary policy, as would be required by a coordinated system.

I think that's a very clear indication that there is not even an understanding of the requirements of target zones.

The last argument is that target zones are a way of educating governments to good behavior. I think the evidence we have now of an unwillingness to lower interest rates in Europe shows how very far we are away from sensible coordination, even in instances when it's really free; when lower interest rates help us to have growth, help us to improve budget deficits, if even in that condition, we can't get coordinated action, surely, fixing the exchange rate is the very last thing we should go on to do.

Thank you.

[The prepared statement of Mr. Dornbusch follows:]

PREPARED STATEMENT OF RUDIGER DORNBUSCH

The Dollar and the Exchange Rate System*

The 1986 discussion of the world macro-economy features three important problems:

- Dollar depreciation: There is a widespread belief that the dollar must decline further to solve the problems of U.S. trade and external debt. The issue here is how much of a decline is required and whether there are large costs of a further decline.

- Interest Rate Reduction: There is a striking international lack of agreement on interest rates. Real interest rates remain extraordinary high by historical standards and there is no plausible reason to stand in the way of substantial cuts, especially abroad. The lack of international agreement on interest rate policy dramatizes the unwillingness of countries to coordinate policies even in cases where there ought not be any problem.

- Exchange rate stabilization: The dollar overvaluation of the past years and the large swings in exchange rates have led to a renewed interest in more nearly fixed exchange rates. The proposals range over a wide spectrum from an outright return to gold to more limited arrangements in the form of target zones, hard or soft, fixed or variable, public or confidential. I do not see much merit in such proposals. They fail to address seriously the problem that if key macroeconomic variables--specifically real interest rates and structural budgets-- go unco-ordinated exchange rate targetting may make things worse by shifting inconsistencies from trade to other sectors of the economy. I will address these three issues in turn.

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*Statement prepared for the Roundtable on the Dollar and the Exchange Rate System, Joint Economic Committee, Subcommittee on Economic Goals and Intergovernmental Policy, February 21, 1986.

How Much of a Further Dollar Decline?

Table 1 shows various measures of the dollar exchange rate. The two top rows document bilateral, nominal rates for the key currencies: the DM/$ and Yen/$ rate. The third row shows the multilateral, real exchange rate that represents U.S. international competitiveness. The table highlights the vast appreciation of the dollar between 1978-80 and February 1985. It also brings out the substantial decline since early 1985. In fact by February 1986 the inflation-adjusted exchange rate of the dollar was less than 5 percent above the 1970-85 average. The same point comes out in Figure 1 which shows the actual real exchange rate and the 1972-85 average. Given how close the late 1985 level is to the average it might be argued that no further depreciation is required.

Table 1 The Dollar Exchange Rate

	1978-80 Average	1985 February	Year	1986 February
DM/$	1.89	3.30	2.94	2.35
Yen/$	219	260	239	182
Real Rate Index*	88	130	121	107

*Morgan Guaranty real effective exchange rate index, 1980-82=100. The average for the period 1970-85=102.

Figure 2 shows the U.S. net exports (in the national accounts) as a fraction of GNP. The current account deficit in late 1985 showed an unprecedented decline reaching 3.4 percent of GNP or about $136 billion. The large external deficit, of course, suggests that there is a significant need

Figure 1
The U.S. Real Exchange Rate
(Index 1980=100)

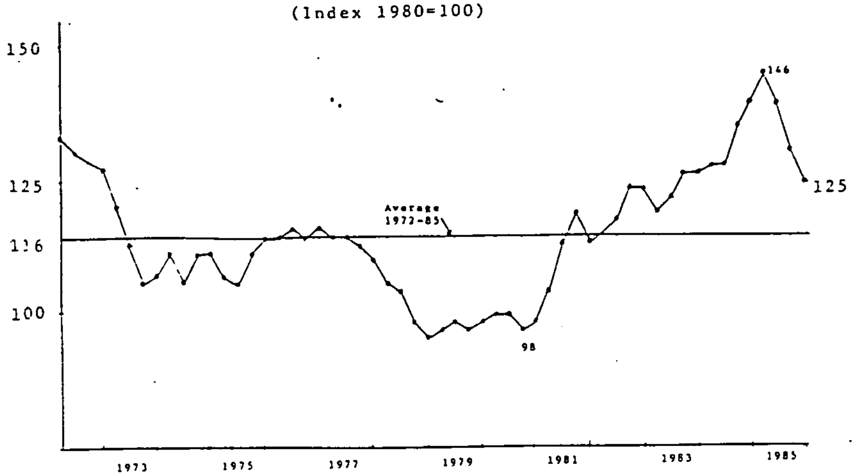
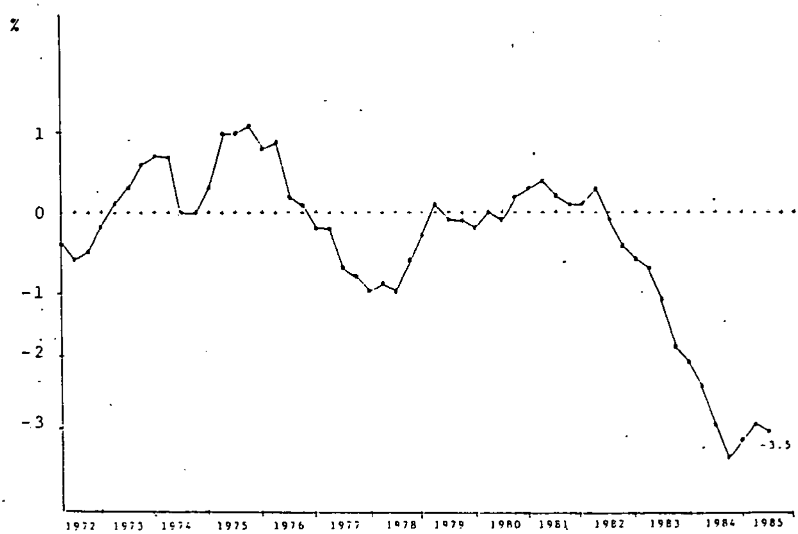


Figure 2
U.S. Current Account (% of GNP)



for adjustment and hence almost inevitably a case for more depreciation. But it must also be recognized that past depreciation already has put in the pipeline a sizeable improvement in the external balance which will come with lags reaching up to two years.

The question whether a further dollar decline is required, and perhaps urgently, can be addressed from three different points of view. The first, immensely crude, looks at the 1978-80 real exchange rate, declares it to be the !equilibrium" real exchange rate and simply infers that there is further depreciation that must inevitably come. This approach is particularly common in manufacturing where the late 1970s are rembered as a period where there was no particularly strong competitive pressure on domestic producers.

An alternative view highlights the implications of deficits for debt accumulation and argues that even after the 1985 realignment,and recognizing gradual adjustment of the external balance already in the pipeline, the real exchange rate remains too high to be consistent with a substantial narrowing of the external deficit. But failing further adjustment the U.S. external debt would build up relative to GNP and exports in a manner that ultimately becomes unacceptable to portfolio holders. Hence now or later the dollar must take another corrective plunge, or else U.S. interest rates must rise relative to those abroad to maintain investors in their dollar positions.[1]

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[1]This argument was advanced with foresight by Paul Krugman in his " Is the Strong Dollar Sustainable?" NBER Working Paper No. 1644, June 1985 even before the adjustments of the past few months. A more dramatic version has been offered for some years by Stephen Marris <u>Deficits and the Dollar: The World Economy at Risk</u>, Institute for International Economics, 1985.

The third perspective focusses on the world economy and notes that the U.S. external balance is affected not only by the real exchange rate but also by relative activity here and abroad and by the real price of oil. In this view the potential of a significant decline in the real price of oil and somewhat more rapid growth abroad, in combination with the dollar adjustment that has already occurred, will suffice to wipe out the deficit over the next few years. This view highlights the need to sustain U.S. growth and an improvement in our external balance by more growth in spending in Europe and in Japan rather than by a policy of shifting demand from the rest of the world toward the United States. The reason for this focus is that Europe suffers depression levels of unemployment and thus is hardly in a position to give up competitiveness. Japan, however, is in need of a structural adjustment: increased spending both in infra-structure investment and also a reduction in the high rates of household saving.

The Japanese adjustment is made particularlyly important by the increasing trade confrontation which Japan faces as long as the country saves a lot and invests domestically little at least relative to the high rate of saving. Much as the recognition in the early 1970s that environmental problems made it inevitable to accept a lower rate of growth, Japan ought to develop a national consensus now that the time has come for reduced external surplusses and an improved standard of living. For both Europe and Japan higher growth in spending is a remedy that helps them and us.

The emphasis on increased spending in Europe and in Japan dispenses with the need for further gains in U.S. competitiveness as a means of external balance adjustment. Of course, it raises the question whether foreign countries will in fact adopt these more expansionary policies if not immediately at least in the next few years. If they fail to do so the point only highlights that the responsibility for adjustment in any target exchange rate setting falls primarily on deficit countrie.

To place in perspective the contribution of increased spending in the rest of the world and of lower oil prices we draw on an equation for net exports.2 The forecasting equation shows that if competitiveness, the real price of oil and relative activity levels remain at their 1985:4 level the external deficit will fall from 3.4 percent of GNP to the range of less than 2 percent. The improvement arises from the gradual adjustment of the external balance to the dollar depreciation during 1985 adjustment in exchange rates and will not be complete until 1988.

But even after the adjustment is complete a quite sizeable deficit would still persist. The remaining deficit implies accumulation of debt which, via increasing interest burdens, ultimately might lead to unsustainable deficits and debt burdens. Thus, although the prospective adjustment to past exchange rate depreciation goes some way it may not be enough. Hence the interest in lower oil prices and stronger foreign spending as alternatives to further depreciation. If real oil prices decline relative to their late 1985 levels or if foreign activity starts to expand more rapidly than our own, a large extra improvement of the external balance must be expected.

The importance of relative activity levels and the real price of oil is quite apparent. If demand grows abroad more rapidly than in the United

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[2] The underlying equation for net exports as a ratio of GNP is reported in the appendix.

States our exports will show rapid increases relative to our own import spending; and, as a result, the external balance improves. Likewise, if the real price of oil declines significantly, as now appears possible, our real import bill would fall in a major way, thus improving the external balance. A cumulative extra 7 percent growth of industrial production abroad relative to the U.S. will reduce the deficit by a full percentage point as does a drop of real oil prices to 50 percent of their 1985 level (i.e $15/barrel oil).3 The adjustment of the external balance by a combination of lower oil prices and more rapid growth abroad thus is a definite possibility and it argues against a policy of seeking maximal dollar depreciation.

The argument for significant further depreciation arises in the context of domestic growth. As budget correction occurs the growth of domestic spending tends to slow down. Foreign expansion and lower oil prices might not come in time or yield sufficent impetus to U.S. growth to provide enough of an offset for the reduction in demand. A larger swing in the external balance then is desirable as a domestic stabilisation policy. That argument is correct, but it must be noted that if budget correction does not in fact take place over the next few years an improved trade balance will impose significant costs on the economy. The U.S. economy is not in my judgment far away from feasible fullemployment. Significant extra growth from a swing in the trade balance would therefore quite possibly lead to overheating with the resultant risk of accelerating inflation. If the Fed were to accommodate the

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[3] In the period 1980-85 U.S. real gross domestic spending increased cumulatively 12 percent more than real spending in the other main industrial countries. This very rapid growth in spending, promoted by our highly expansionary budget policy without an offsetting increase in saving rates has directly contributed to the sharp deterioration in the external balance.

inflationary pressure a reenactment of 1978-80 is likely. But if the Fed does not accommodate interest rates will be pushed up; and crowding out will be shifted from the external sector to interest sensitive domestic industries, especially housing, consumer durables. and investment. Thus it can be argued that we would merely trade an improved external balance for a decline in investment.

But even if there were budget correction, so that there is no inflation from the cyclical side, a depreciation policy still comes at a serious risk and cost. A sharp and fast depreciation of the dollar risks putting up U.S. inflation by a sizeable amount. With a large depreciation already having occurred some extra inflation is very likely to be already on the way. I thus find it doubtful whether more depreciation is desirable.

Estimates of the impact of dollar depreciation on prices differ widely. There is a consensus that the movements in the dollar !do" have a significant impact on inflation, even if the precise estimates differ widely. The range of estimate is that a 10 percent dollar depreciation would raise prices between 1 and 1.5 percent within three years relative to where they would otherwise have been. Some estimates show even larger and more rapid reactions. Quite clearly there is thu an inflation cost to seeking extra growth via improvement in the trade balance. This is an essential element of the case for a reduction in world interest rates in preference to competitive depreciation. Unlike exchange rate depreciation it poses no significant inflation risk at this time.

The inflation concern is less of an issue, however, if a large and sustained decline in oil prices does come about. The impact of oil on the inflation process is substantial and may well outweigh the effect of depreciation. And, of course, if a large and sustained decline in oil does occur, the depreciation is less required for external balance. At the same time the terms of trade improvement from lower oil prices raises real income and hence demand. Thus lower oil prices, all things considered, undermine the case for depreciation. While inflation is not a risk in this event there is also much less of an argument for depreciation.

Lower World Interest Rates

The overriding priority for the world economy is lower real rates of interest. For the past four years real interest rates have been exceptionally high by historical standards, both in the United States and abroad. The high real interest rates hold back investment everywhere and caused debt problems, most visibly in Latin America, in the farm sector and in government budgets everywhere. So long as expansionary U.S. fiscal policy sustained the economy the impact of high real interest rates was concealed or at least dampened. Now, with the prospect of budget correction it becomes an all-important issue. To secure continued growth in output and employment, satisfactory capital formation, reduced debt problems and an improved budget outlook much lower interest rates are an absolute requirement. It is not enough to let interest rates decline as a result of the decline in demand brought about by fiscal correction, since that would simply leave the economy in an incipient recession. There needs to be a shift in the monetary-fiscal mix that sustains demand in the face of budget cuts. Monetary policy has to play an active role pushing down interest rates both here and in the other industrial countries.

Table 2 shows interest rates and inflation rates in several countries. To have a perspective on what levels of real rates have prevailed historically it is worth recalling that the average real return on T-bills between 1927 and 1976 was 0 percent and that for longterm bonds only 1 percent. By comparison today real rates continue in the 3-4 percent range at the short end and potentially much more for longterm bonds. That experience is not unique to the United States. In Germany, for example, the 1985 shortterm real rate was at the highest level of the past 25 years. In the United Kingdom the shortterm real rate is upward of 8 percent and in Japan it is as high as 5 percent.

Table 2 Interest Rates and Inflation
(Percent per Year, February 1986)

	U.S.	Germany	Japan	U.K.
Interest Rates				
Shortterm	7.8	4.6	6.5	13.4
Longterm	9.2	6.3	6.2	10.3
Inflation				
Consumer Prices*	3.8	1.3	1.8	5.7
Wholesale Prices**	-0.9	-0.1	-9.8	3.4

*Past 12 months, **past 3 months at an annual rate

The common argument against more expansionary monetary policy for the world economy is that there is inflation risk. For the individual country this is certainly a serious problem: more rapid monetary expansion and a decline in interest rates would lead to capital outflows and to exchange depreciation, which is a potent and almost immediate source of increased inflation. But clearly if the major countries cut interest rates jointly risk of exchange rate movements is absent. The argument that increased money growth, always, everywhere and without qualification raises inflation is unrealistic. A transitory increase in money growth at constant exchange rates and under conditions of near-deflation poses no significant and unacceptable inflation risk.

The only question in a joint expansion is whether world and individual countries' cyclical position can justfify more rapid growth via lower interest rates. In Europe this cannot be doubted since unemployment remains at record levels--more than 11 percent and at best constant, certainly not falling. In the U.S. the prospective fiscal correction creates the room for stimulus or "crowding in" via interest rate cuts. In Japan the large real appreciation and timid fiscal moves leave scope for increased domestic demand expansion. In each of the regions inflation is extremely low when measured by consumer prices, and wholesale prices are actually falling. There is accordingly no serious argument against cutting interest rates by a transitory increase in the rate of monetary expansion.

Those who feel that proposing increased money growth is reckless should remember that in the aftermath of every inflation stabilisation real balances are low and hence equilibrium real interest rates are high. Reliquification of the economy, preferably not via recession or depression, is thus an essential part to complete the stabilisation. It always raises the touchy issue of the monetary authorities losing credibility. The Fed's policy over the past three years demonstrates amply that there is room for money "blips". The argument here is to have another helping of the same.

Co-ordinated expansion has had a bad name since the late 1970's when the locomotive theory of joint expansion in Europe and in the U.S. dragged the world economy into sharply higher inflation. The situations today is different in three respects: First, the 1978 expansion occurred in the midst of a sharp increase in oil prices whereas today oil prices appear to be collapsing. Second, unemployment then was very low everywhere, while today it certainly is extremely high in Europe. Third, inflation then was significant but today is less than 4 percent for the OECD countries. Whatever the merits of the 1978 expansion, the conditions today are favorable and the need for interest rate cutting is much more dramatic.

The only surprise is that Germany should not have used the fact of an appreciating mark to cut interest rates and thus give all of Europe a shot at some extra, badly-needed growth and budget relief. It is worth emphasizing the budget implications of lower interest rates becauseof fiscal tightening is the very source of Europe's unemployment. Lowering of interest rates both cuts the budget deficit !and" expands demand, output and employment. It thus gives something free and one would think politicians would seize the opportunity with both hands. While one can imagine a reluctance to widen budget deficits for the purpose of cutting unemployment, especially by those who believe this is at best a temporary palliative, the opportunity to cut deficits and generate growth at the same time, without apparent costs, is outright baffling.[4] It certainly is an area where the U.S. should exert international leadership and pressure. Of course, that is quite impossible unless we ourselves improve our fiscal policy.

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[4] For a challenge to German policy ideology see the address by Anthony Solomon, former president of the New York Fed, to the American Economic Association and American Finance Association :"Economists and Economic Policies in the Past Five Years", New York, December 28,1985.

Managed Exchange Rates: Coordination and Target Zones

Our inability to obtain a world-wide cut in interest rates dramatizes the difficulty of getting international macroeconomic coordination even in a situation where all players can be ahead. In more complicated situations involving sacrifices on growth or on inflation, the near-impossibilty spells trouble for any international agreement to limit the fluctuations of exchange rates. The assumption that exchange rate fluctuations can and !should" be limited, without the need for complementary domestic and international measures, is difficult to understand even if it commands wide support. It reflects an instinctive and superficial reaction that anything which moves a lot, moves too much. The argument is that excessive volatility and persistent misalignment, which may not even represent fundamentals, have large costs in terms of resource allocation. These costs are avoidable, it is argued, by a more closely managed exchange rate system.

Excess Variability: One line of argument for a target zone system relies on the view that asset markets are highly speculative and not necessarily rational. They put prices on assets that need not correspond to fundamentals, but which in turn do have an important impact on the economy. An overvalued dollar leads to undesirable external indebtedness and domestic de-industrialisation. If intervention can be effective then policy makers should step in and push the exchange rate in the direction of the equilibrium value that governments can identify and point out to speculators. By deliberately creating disorder in the exchange market, they scare speculators off the wrong price and in the direction warranted by fundamentals. The action in September by the G-5 would be seen as an implementation and vindication of this view.

The difficulty with this view is to know what a disequilibrium price is, and to know whether and when intervention should take place in markets where mispricing can be suspected. The point is best made by Figure 3 which shows real stock prices (the S&P index delated by the GNP deflator) for the United States in the past decade. What were the fundamentals that caused asset prices to be at a record low in 1982 and then to increase by 50 percent in the span of three years. Is the 1982 level too low, or the present level too high? There is certainly no question that the stock market is as significant for the good performance of the U.S. economy as is the exchange rate. The stock market affects investment and hence competitiveness and, via wealth, it has a significant impact on consumer spending and hence employment. No doubt it is central, no doubt we should have target zones to avoid the erratic and irrational fluctuations.[5] This argument is all the more forceful in that stock market variability is more than twice the level of exchange rate variability.[6] Exactly the same argument applies to longterm bond prices which also show seemingly erratic fluctuations and have, of course, a major impact on the economy.

Many economists would be coy about target zones for interest rates and for the stock market. They would ask immediately how these target zones are to be made to stick. They would certainly be concerned if the answer were monetary policy. Fixing target zones for interest rates--independently of

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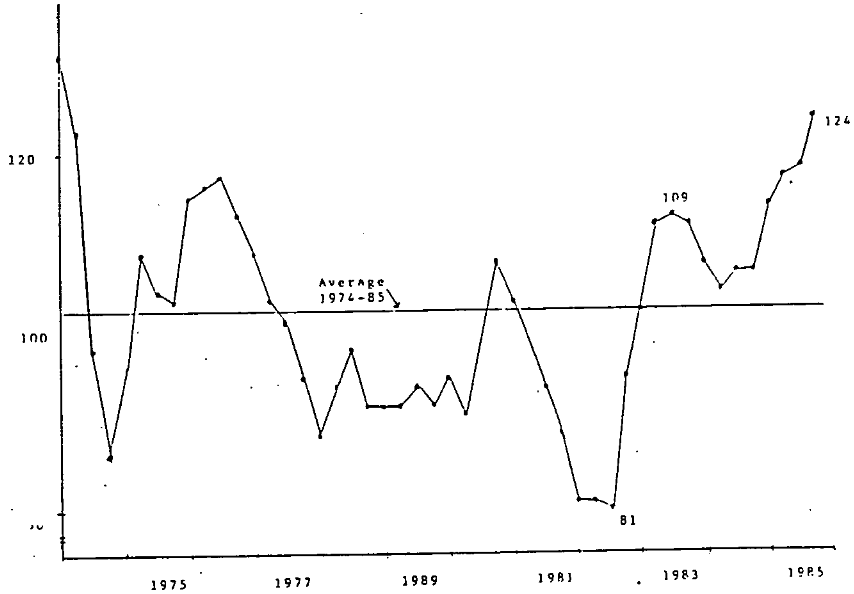
[5] This argument has, in fact, been advanced by Stanley Fischer and Robert Merton "Macroeconomics and Finance: The Role of the Stock Market." In Carnegie Rochester Conference Series, Vol. 21, Autumn 1984.

[6] The coefficients of variation of real stock prices and the U.S. real exchange rate for the period 1972-85, using quarterly averages, were respectively 20.8 and 10.3 percent.

Figure 3
The Rsal Value of Stock Prices
(Index 1980=100)



fundamentals--is long known to be a safe way of generating inflation. The same applies to fixing the real value of the stock market. What then is different about target zones for exchange rates? In fact the problem is exactly the same, the only difference is that target zones for interest rates or the stock market are (perhaps excessively) discredited while exchange rate fixing is a fad that has a way of coming back.

Even if it was quite obvious that an exchange rate was misaligned there would still be a policy issue to be resolved. Clearly moving the exchange rate will have macroeconomic effects. There will be effects on aggregate demand and on prices. In the U.S. case, for example, manufacturing is quite certainly suffering from an overly strong dollar, but it is also clear that a 2.5 % of GNP swing of our external balance and pressure on import prices creates a macro disequilibrium that can easily push up inflation. It is not obvious that a better-aligned exchange rate is a good trade-in for a significant increase in inflation. At a minimum, one must ask what macroeconomic policies should accompany (here and abroad) a realignment of rates. It may be impossible to avoid the coordination issue.

Insufficient Instruments: If one takes the view that large changes in exchange rates reflect primarily fundamentals, there is a different problem. Either governments are willing to let exchange rates move to accommodate the change in fundamentals. In that case we face a serious political issue that is well-illustrated by the shifts in fiscal policies in the 1980s.

The main point in understanding the 1980-85 appreciation of the dollar is to recognize that it reflects a vast shift in the monetary-fiscal mix.

Fiscal policy in the U.S. shifted to a massive deficit, while abroad, over the same period, there was an unprecedented fiscal consolidation. Table 3 shows the extent of deficits and the cumulative shift in structural deficits.

Table 3 General Government Budget Deficits
(Percent of GNP)

	1974-79 Average	1980-84 Average	1985	Change in Adjusted Deficit: 1980-85
U.S.	1.3	2.7	3.7	4.5
Japan	3.4	3.7	2.9	-3.2
Germany	3.0	2.9	1.5	-4.2

There is no surprise that exchange rates should move in an unprecedented way. But equilibrium real exchange rates must move in a case of fiscal shifts in a well-functioning target zone system. The authorities in the expanding country thus would be required to announce that they had chosen to reduce competitiveness by a deliberate shift in target zones to accommodate the expansionary fiscal stance. It is altogether inconceivable that such a move would take place, certainly not while there was any unemployment as in the U.S. in 1980-85. On the contrary there would be great reluctance to deliberately accept a move of the target zone. As a result monetary policy would be enlisted to defend disequilibrium exchange rates.

Much the same problem arises if target zones are hard rather than soft. If they amount practically to a system of fixed nominal rates independent of fundamentals. Suppose in this setting a country sets out to stabilize inflation by reducing money growth. If wage-price controls are not used, the ordinary channel will be an increase in interest rates to bring about the recession that slows down inflation. The increase in interest rates in turn attracts capital that leads to appreciation. If the country were following a policy of rigid target zones there would be a lot of difficulty in achieving a reduction in inflation. Monetary policy would have to avoid the appreciation and could not turn restrictive in the first place. The argument is reinforced if at the very time of inflation stabilisation the economy is driven by expansionary fiscal policy. Now to hold the exchange rate, monetary policy would in effect have to monetize the deficits. The exchange rate would remain unchanged and, there would be no crowding out, and a maximum of inflation. This is, of course, what would have happened in the U.S. in the 1980-85 period if monetary policy had defended the 1980 value of the dollar in the face of the Kemp-Roth tax cuts. The Volcker disinflation would simply not have occurred.

The upshot of all this is that it is absurd to discuss exchange rate issues as if we had not had the most extreme peace-time fiscal shock of the past two centuries. As long as legislatures or administrations reserve the privilege to enact such follies market prices, from exchange rates to interest rates will adjust; fixing some will quite possibly make others move even more. The lesson is that large international divergences in monetary and/or fiscal policy will be reflected in exchange rates. To avoid these fluctuations bad the policies must be avoided. Accommodating a poor fiscal policy by exchange-rate oriented monetary policy simply adds yet another folly. Optimal Exchange rate targetting presupposes that autonomous monetary and fiscal policy is given up by us-- an absurd way of backing into worldwide coordination of macro policies.

Institution-Building: Some analysts who favor target zones recognize these arguments.7 They understand that an effective system of target zones requires international coordination of monetary !and" fiscal policies. They also recognize that as yet we do not have an effective coordination. But they would argue that it is the role of institutions to promote good policies. Hence target zones for exchange rates would be a first step in the direction of educating governments to pursue good policies. In the U.S. case the Kemp-Roth tax cut bout would have run into exchange rate problems and Congress, recognizing the target zone commitment, would simply have rescinded the tax cuts. Europe, in the same way, would have abstained from fiscal consolidation.

It is difficult to believe that such conditions for international monetary and fiscal coordination are at hand. No government will sacrifice its fiscal autonomy to an exchange rate target. The U.S. will not, neither the administration nor Congress, nor will Germany, Japan or the U.K. This is simply well-intentioned pie in the sky, rhetoric and implausible rhetoric. Promoters of target zones should be quite frank to admit that without fiscal coordination their scheme will more often than not involve abuse of monetary policy to make up for the lack of fiscal coordination. It therefore may well introduce even more instability. This is certainly the case since there has as yet been no convergence of fiscal policies.

The difficulty observed in securing a joint cut in world interest rates at the present time further highlights the impossibility of achieving coordination. It is entirely correct to try and build institutions that

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[7] See, for example, John Williamson The Exchange Rate System, Institute for International Economics, June 1985.

ultimately help prevent the pursuit of unreasonable policies. But in this respect the world economy is at a very early stage where the negotiation of an ad hoc consensus, for example on interest rates, is the best we can hope for.

APPENDIX

This appendix reports on an equation for U.S. net exports relative to GNP. The equation explains the U.S. current account balance to GNP ratio (CUR) by three variables: the real price of oil (OIL), the real exchange rate (REX) and the level of activity in the U.S. relative to the rest of the world (ACT). The equation is estimated using quarterly data for the period 1970-1985:3.

$$\underset{(8.9)}{CUR = 117.4} - \underset{(-4.6)}{1.70 \cdot OIL} - \underset{(-5.2)}{9.2 \cdot REX} - \underset{(-4.7)}{14.6 \cdot ACT} \qquad R2=.79 \quad DW=1.97 \quad Rho=.36$$

The real price of oil is measured by world crude oil prices deflated by the US GNP deflator. The real exchange rate is the IMF's multilateral exchange rate corrected for value added deflators in manufacturing. Relative activity is measured by the U.S. industrial production level relative to that in thwe other industrialized countries, using OECD weights. All right-hand side variables are in logs. The real exchange rate is entered as an unconstrained 8-quarter distributed lag.

The equation implies that to generate a one half percentage point improvement in the current account to GNP ratio the following changes are alternatively required:

- a 30% decline in the real price of oil.
- a 5.4% real depreciation.
- a 3.4% increase in foreign relative to U.S. industrial production.

Thus the external balance responds very strongly to all three variables. Looking ahead a major change in oil prices or in foreign growth would be very significant factors in improving the U.S. external balance.

Representative HAMILTON. Mr. Branson, we're glad to have you join us here and we'll go ahead with Mr. Cooper's statement, and then come to you and your statement, and then Mr. de Vries.

Mr. Cooper, please proceed.

STATEMENT OF RICHARD N. COOPER, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. COOPER. Thank you. I have a short statement. There is a short-term issue with respect to the U.S. dollar, and a longer term issue of how exchange rates among major countries should relate to one another over time. I will attempt to address both of these issues briefly.

Unlike Mr. Dornbusch, I believe that the U.S. dollar remains too strong against the yen, and especially against the German mark and the other European currencies closely tied to the mark. And it would be desirable to make the correction, which I reckon to be on the order of 10 to 20 percent, as rapidly as possible. There are five reasons for wanting to drop quickly against other major currencies.

First, to ward off protectionist action by the U.S. Congress by alleviating the protectionist pressures from American industry and labor. These pressures arise from difficulty in competing with foreign goods, leading to the huge U.S. trade deficit that the United States has experienced during the last 2 years. There is wide agreement that much of the trade deficit is due to the strong dollar. The dollar has dropped substantially from its peak in real terms, which was 1 year ago, but I think that some additional drop would be desirable.

Second, to provide some early stimulation to the U.S. economy in the face of the severe budgetary contraction that will take place under the Gramm-Rudman Act, the current budgetary guideline to both the executive branch and the Congress.

Meeting the budget deficit targets of this act will impose a recession on the United States unless it is alleviated by some easing of monetary policy and by some action which will stimulate net U.S. exports. The easiest way to provide some offset to the contractionary impact of the reduced budget deficit is to have a further drop in the dollar.

Third, a gradual drop in the dollar will act as a disincentive to foreigners to invest in the United States. As long as we have a large current account deficit we will need foreign investment in the United States. I think it is important to get the capital losses, which are inevitable, behind us as soon as possible, and that also suggests a rapid rather than a gradual drop in the dollar so that foreigners will make their investment decisions on the then current values and interest rates will not have to be increased in order to attract foreign funds.

Fourth, to absorb the price increase that must, again inevitably, come from a correction of the dollar relatively quickly, during a period in which oil prices are falling, and thus to avoid a prolonged rise in the price level which will inevitably be confused in the public mind with a revival of inflation. There is at least a chance that a once-for-all rise in the price level can be explained to the

American public for what it is, the consequence of a once-for-all drop in the dollar.

Fifth, to put pressure as rapidly as possible on Japan and West Germany and some smaller countries to increase domestic demand within those economies. Both Japan and Germany, along with several others, have been pursuing extraordinarily contractionary fiscal policy, as Dornbusch has pointed out, which has contributed to the strength of the dollar and to the weakness of the world economy in general and of U.S. exports in particular.

This drop in the dollar, in my view, can be accomplished by a combination of several actions:

First, a stated commitment by senior U.S. officials to lower the value of the dollar. Secretary Baker has already indicated his preference in that regard.

That should be accompanied, in my view, by intervention in the foreign exchange market to buy German marks and Japanese yen; also by a more stimulative U.S. monetary policy.

My view on monetary policy is not that it ought to be stimulated in order to reduce the dollar, but that we need some monetary stimulation anyway, and that can contribute, in conjunction with intervention in the foreign exchange market, to a declining dollar.

These actions, in combination and under current circumstances, will in fact reduce the value of the dollar against the other major currencies.

Once we get through this current period, I believe that monetary policy, in response to one of the questions in your letter, should respond to movements in the dollar exchange rate, but it should not be focused exclusively on the exchange rate in the near future.

The United States remains the single most important national economy in the world, and its monetary policy sets the tone for world monetary policy. Inevitably, therefore, the guidelines for setting U.S. monetary policy must be complex. The exchange rate should be among them, but it should not be the predominant determinant, indeed, cannot be the predominant determinant of U.S. monetary policy.

Let me turn briefly to the longer term question.

I believe that the present set of exchange rate arrangements, which allow for maximum freedom of major currencies to move against one another in response to market pressures, is not sustainable. It is not likely to collapse suddenly or any time soon, and indeed in many respects it has served well the world economy during a very turbulent decade. But market exchange rates are increasingly determined in the short run by movements of financial capital, whether motivated by economic or political considerations.

Yet these movements of capital, impinging on exchange rates, can affect radically the profitability of firms and farms around the world, whether they are selling in the world market or at home in competition with imports.

Producers, I forecast, will not find acceptable the uncertainties created for reasons beyond their knowledge and their understanding, and they will press governments into actions to insulate their transactions from such uncertainty, to provide a more stable economic environment in which they can make decisions with respect to investment and production.

Unless the international monetary system can be arranged in such a way as to provide the stability, I suggest that it will be provided through the introduction of growing restrictions by governments on both capital and trade transactions between countries.

I think that these restrictions will in themselves be undesirable, but they will be motivated by the desire to provide a more stable economic environment for domestic producers.

It should therefore be a longrun objective of governments to maintain an open world economy but to arrange their affairs so that greater stability of real values is maintained for the sake of efficient production and investment.

In the limiting case, this would call for a world—or more accurately, a world encompassing the major industrial democracies—a world of a single currency, in which the fluctuations in currency values could not introduce seemingly arbitrary and often capricious elements into business decisionmaking.

Governments are not today ready to contemplate such a radical move, which would require a single monetary policy for that single currency and some institutional arrangement for determining that single monetary policy which surmounts the authority of today's national central banks. But this longer run objective should be kept in mind.

In the meantime, I think it would be desirable to encourage official examination of a number of proposals that have been put forward with the aim of avoiding misalignments of exchange rates among major currencies in the future, including those that are associated with target zones or reference rates.

These schemes may in fact turn out to be technically flawed in one way or another, but the process of discussing them officially will encourage the kind of international cooperation in macroeconomic and exchange rate management which is necessary for greater exchange rate stability.

I think it would be premature to move to a system of target zones or reference rates so long as trade imbalances remain as large as they are today. For this reason, also, therefore, it would be desirable to have a corrective movement in exchange rates as rapidly as possible.

Mr. Chairman, I have disagreements with Mr. Dornbusch on what exactly is required to maintain a system of more stable exchange rates, but perhaps we can come back to that in the discussion.

Representative HAMILTON. Let's come back to that after you have all completed your statements, I will ask for you to comment on your colleagues' statements for criticisms.

[The prepared statement of Mr. Cooper follows:]

PREPARED STATEMENT OF RICHARD N. COOPER

Exchange Rates and Monetary Reform

The issue before the committee is exchange rates. There is both a short-term issue with respect to the U.S. dollar in terms of other currencies, and a longer term issue in terms of how exchange rates among major currencies relate to one another over time. I will attempt to address both of these issues in the brief time allotted.

I believe that the U.S. dollar remains too strong against the yen and especially the German mark and the other currencies closely tied to the German mark, with the strength against the mark being rather greater than against the yen. It would be desirable to make the correction, which I reckon to be on the order of 10-20 percent, as rapidly as possible. There are five reasons for wanting the dollar to drop against other major currencies:

- First, to ward off protectionist action by the U.S. Congress by alleviating protectionist pressures from American industry and labor. These pressures arise from difficulty in competing with foreign goods, leading to the huge U.S. trade deficit that the United States has experienced during the last two years. Much of this trade deficit is due to the strong dollar. The dollar has dropped substantially from its peak (in real terms) one year ago, but some additional drop would be desirable.

- Second, to provide some early stimulation to the U.S. economy in the face of the severe budgetary contraction that will take place under the Gramm-Rudman act, currently the budgetary guideline to the U.S. government. Meeting the budget deficit targets of this act would impose a recession on the United States unless it is alleviated by some easing of monetary policy and by some action which will stimulate net U.S. exports. The easiest way to do this rapidly is to have a further drop in the dollar.

-Third, to put inevitable capital losses on the dollar holdings of foreign investors behind them as rapidly as possible. The United States must borrow extensively abroad for several more years, and the prospect of a gradual decline in the dollar will require higher U.S. interest rates than if the drop is once-for-all.

- Fourth, to absorb the price increase that must inevitably come from a correction of the dollar relatively quickly. In a period in which oil prices have fallen and will thus mitigate the drop in the value of the dollar, and to avoid a prolonged rise in the price level which will inevitably be confused with the a revival of inflation. A once-for-all rise in the price level can perhaps be explained for what it is to the American public, without triggering new fears of inflation.

- Fifth, to put pressure as rapidly as possible on Japan and West Germany to increase domestic demand within those two economies. Both countries — along with several others — are pursuing extraordinarily contractionary fiscal policy, which has contributed to the strength of the dollar and to the weakness of the world economy in general and of U.S.

exports in particular.

This drop in the dollar can in my view be accomplished by a combination of several actions: 1) a stated commitment by senior U.S. officials to lower the value of the dollar. This should be accompanied by 2) intervention in the foreign exchange market to buy yen and German marks, and 3) a more stimulative U.S. monetary policy. These actions, in combination and under current circumstances, should serve to lower the value of the dollar against other major currencies. Hereafter, I believe that monetary policy should respond to movements in the dollar exchange rate, although it should not be focussed exclusively on the exchange rate in the near future. The United States remains the single most important national economy in the world, and its monetary policy sets the tone for world monetary policy. Inevitably, therefore, the guidelines for setting U.S. monetary policy must be somewhat complex. The exchange rate should be among them, but it should not necessarily predominate.

With respect to the longer term question, I believe that the present set of arrangements, which allows maximum freedom of the major currencies to move against one another in response to market pressures, is not sustainable. It is not likely to collapse suddenly, or any time soon, and indeed in many respects has served well the world economy during a turbulent decade. But market exchange rates are increasingly determined in the short-run by movements of financial capital, whether motivated by economic or political considerations. Yet these movements of capital, impinging, on exchange rates, can affect radically the profitability of firms and farms around the world, whether they are selling in the world market or even only in the home market but in competition with imports. Producers will not find acceptable the uncertainties created for reasons beyond their knowledge and understanding, and they will press governments into actions to insulate their transactions from such uncertainty, to provide a more stable economic environment in which they can make decisions with respect to investment and production. Unless the international monetary system can be arranged in such a way as to provide the stability, I forecast that it will be provided through the introduction of growing restrictions by national governments on both capital and trade transactions between countries. These restrictions will in themselves be undesirable, but they will be motivated by the desire to provide a more stable environment for domestic producers. It should therefore be a long-run objective of governments to maintain an open-world economy and to arrange their affairs so that greater stability of real values is maintained for the sake of efficient production and investment decisions. In the limiting case, this would call for a world — or at least a world encompassing the major industrial democracies — of a single currency, in which fluctuations in currency values could not introduce seemingly arbitrary and often capricious elements into business decision-making. Governments are not today ready to contemplate such a radical move, which would require a single monetary policy for that single currency, and some institutional arrangement for determining that single monetary policy which surmounts the authority of today's national central banks. But this longer-run objective should be kept in mind.

In the meantime, it would be desirable to encourage official examination of a number of proposals that have been put forward with the aim of avoiding "misalignments" of exchange rates among major currencies, including those that are associated with target zones or reference rates. These schemes may turn out to be technically flawed in one way or another, but the process of discussing them officially will encourage the kind of international cooperation in macro-economic and exchange rate management which is necessary for greater exchange rate stability.

It would be premature to move to a system of target zones or reference rates so long as trade imbalances remain as large as they are today. For this reason also, therefore, it would be desirable to have a corrective movement in exchange rates as rapidly as possible.

Representative HAMILTON. Mr. Branson, please proceed.

STATEMENT OF WILLIAM H. BRANSON, PROFESSOR OF ECONOMICS AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY

Mr. BRANSON. Thank you, Mr. Chairman.

In these opening remarks, I will end up by focusing on the analysis of the roles of fiscal shifts in monetary policy and moving exchange rates and talk about the feasibility of proposals to coordinate monetary policy using target zones.

Before talking about the analytics of this problem, I thought I would put the short answers to the five questions that were raised in the letter convening this meeting.

First, an exchange rate arrangement that reduces short-term fluctuations in nominal exchange rates by partially targeting monetary policy and exchange rate would improve on the existing system.

An arrangement of that kind, however, cannot be expected to eliminate large swings in real exchange rates, such as the movement of the dollar since 1981, that respond to real shifts in the economy, such as the budget shift that began in 1982.

So not too much should be expected of monetary coordination in a world of real disturbances, such as major fiscal shifts and movements in oil prices.

Second, a new arrangement aiming to hold exchange rate fluctuations within target zones would have to constrain monetary policy either explicitly or implicitly to be effective.

The relationships between monetary and fiscal policy in moving exchange rates would also need to be clarified if an arrangement of this sort were to be feasible.

Therefore, I think some explicit recognition of the constraining effect of fiscal policy on monetary policy along with a clear idea of the limits of the effectiveness of monetary policy would be in order. It is not clear to me that a consensus on the effects of fiscal policy on real exchange rates is sufficiently broad in policy circles to make a target zone proposal feasible now.

Third, it seems to me unlikely that monetary policy could have prevented the broad swing in the dollar in real terms that has occurred since 1981. I think this swing was caused mainly by the announcement and then execution of the shift in fiscal policy, starting in 1981, which was in turn facilitated by U.S. borrowing from abroad.

The dollar appreciation was a necessary factor in arranging that financing, which largely shielded domestic investment from crowding out by fiscal policy.

This said, I think, a monetary policy oriented toward shorter run stability of exchange rates could prevent short swings in real exchange rates that come from exchange rates moving faster than relative prices.

In this sense, a more exchange rate oriented monetary policy could provide a smoother path for real exchange rates but would not prevent the large swings caused by real events that seem these days to be labeled misalignments.

Fourth, I think the dollar will have to fall below its 1981 level in real terms to bring the trade deficit back to equilibrium. There are two reasons for this:

First, when the current account balance returns roughly to zero—and if it does—it will be composed of a deficit on investment income and services and a trade surplus necessary to finance the debt service. The exchange rate would have to fall beyond the 1981 level to provide that surplus.

Second, during the period of appreciation since 1981, U.S. manufacturing has given up much of the competitive gains it made during the depreciation of the 1970's. And I think if you will look at Rudi Dornbusch's chart you see the bottom around 1979 to 1981.

The period of appreciation since 1981 has brought new foreign entrants into industries that were previously sources of strength for U.S. trade. While these foreign entrants have a temporary, but protracted over the period of 5 or more years, cost advantage over the United States, they worked on their cost curves, learned the business, built modern plants.

When the dollar returns to its 1981 level, U.S. industry will face a new world of efficient competitors abroad. Expansion will have to come in new sectors rather than simply reestablishing positions in traditional sectors. The dollar will probably have to depreciate in real terms below the 1981 level to achieve that.

The cost to the economy from this readjustment will be substantial. Restoration of the 1981 exchange rate will not put steel, or autos, or machine tools back in their 1981 competitive position because of the appearance of foreign competition during this interim of appreciation. Movement of the dollar back to the real level of 1981 won't make foreign competitors forget how to manage their technology.

This means that a new expansion in manufacturing will come in sectors and geographical areas of the economy that are different from those that shrank during the period of appreciation. The skills demanded of labor in the expanding industries will differ from those possessed by labor laid off in the contraction and may be in industries that are not located in the contracting Rust Belt.

So I think the need still exists for macrolevel policies that retrain labor force, encourage mobility in job search, aiding communities in restoring lost tax bases. These are the costs that will appear as the cost of adjustment to this decade-long temporary appreciation of the dollar.

Fifth, I think an across-the-board import surcharge makes sense. By reducing the budget deficit, it would help to bring down interest rates on the dollar. The appreciation of the dollar since 1981 has reduced U.S. competitiveness to the peak by some 50 percent. A temporary import surcharge of 20 or 25 percent would recover perhaps half that gain.

And I realize this sounds like heretic deviation from the free trade position, but I think import surcharge as fiscal policy as opposed to trade policy makes sense.

Let me say a few words about the role of fiscal policy, backing up to provide a little analytical backup for the statements I have made.

I think the shift in fiscal policy that was announced in spring 1981 and executed beginning in 1982 is sufficient to explain the movement of the real exchange in the dollar since 1981.

I do not disagree with Professor Dornbusch that the relative fiscal shift is important, the tightening in Europe as well as the easing in the United States are important. I am focusing on things the United States could do here.

The sum of domestic investment and the integrated government deficit has to be financed by the sum of domestic private saving and foreign borrowing. That is the only place we can get the money.

With private saving as a fraction of high employment GNP not particularly responsive to the shift in the deficit, the budget deficit, room for that deficit must be made by a reduction in domestic investment or it has to be financed by an increase in the current account deficit or a combination of these two. A shift in the so-called structural budget deficit of $200 billion, with the ratio of saving to GNP unchanged, requires a combination of reduced domestic investment and increased current account deficit summing to $200 billion to finance it. This is straightforward economic arithmetic.

What movement in the financial markets will generate the needed combination of reduced investment and increased current account surplus? A rise in real interest rates and a real appreciation of the dollar.

The latter, the real appreciation of the dollar, occurred initially across 1981 as the markets came to understand the deficit implications of the fiscal shift.

I would like to note here that the argument that is being made is that the shift in the fiscal position required the adjustment. This doesn't imply anything about the desirable level of the deficit. It is the change in the deficit that requires an adjustment somewhere else in the economy to make room for it.

This argument does imply that calculations that adjust the deficit to make it seem larger or seem smaller are irrelevant. It is the change in the high employment deficit that counts.

The question arises: Can the fiscal shift account for the size of the appreciation of the dollar?

Fortunately, Professors Dornbusch and Jeffrey Frankel have provided an econometric estimate that says that a real dollar appreciation of 13.5 percent reduces the trade balance by 1 percent of GNP.

That says that to get the trade balance to determine by 4 percent of GNP in order to finance its share of the budget deficit by 1985, we would require a 54-percent real appreciation of the dollar. That is about what we got.

So I do not think that the movement—this quantitative movement—of the dollar is out of line with the argument that it was due to the U.S. fiscal shift.

A final question is: Could this be a sustainable position?

No; Paul Krugman has provided the argument in another paper. Eventually, international investors are bound to feel that their portfolios are becoming overloaded with dollars. This means that eventually the dollar has to depreciate, completing the cycle of appreciation and shifting the full load of financing the budget deficit onto domestic investment. In the end, we have to finance our own deficit.

This process, I think, is underway now, and the dollar depreciation will probably continue.

I will stop there.

[The prepared statement of Mr. Branson, together with an attachment, follows:]

PREPARED STATEMENT OF WILLIAM H. BRANSON

I. Summary

It is an honor and a pleasure to join my colleagues in this discussion of the dollar and the exchange rate system before your subcommittee, Congressman Hamilton. The questions you posed are difficult and interesting. In my opening remarks I will focus on the analysis of the roles of fiscal shifts and monetary policy in moving exchange rates, and relate this discussion to the feasibility of proposals to coordinate monetary policy using target zones. As the background for this discussion I have submitted my paper on "Causes of Appreciation and Volatility of the Dollar," NBER Working Paper No. 1777 of December 1985, which I presented at the Federal Reserve Bank of Kansas City's conference last August.

Before proceeding to this analysis, perhaps I should put on the table my short answers to the questions raised in your letter convening this meeting:

1. An exchange-rate arrangement that reduces short-run fluctuations in nominal exchange rates, by partially targeting monetary policy on the exchange rate, would improve on the existing system. An arrangement of this kind, however, cannot be expected to eliminate large swings in real exchange rates, much as the movement of the dollar since 1981, that respond to real shifts in the economy, such as the budget shift that began in 1982. So not too much should be expected of monetary coordination in a world of real disturbances such as major fiscal shifts and movements in oil prices.

2. A new arrangement aiming to hold exchange rate fluctuations within target zones would have to constrain monetary policy, either explicitly or implicitly, to be effective. The relationships between monetary and fiscal policy in moving exchange rates would also require explication if an arrangement were to be feasible. Therefore, some explicit recognition of the constraining effect on monetary policy, along with a clear idea of the limits of the effectiveness of monetary policy, would be in order. It is not clear that consensus on the effects of fiscal policy on real exchange rates is sufficiently broad in policy circles to make a target zone proposal feasible at this time.

3. It is unlikely that monetary policy could have prevented the broad swing in the dollar, in real terms, that has occurred since 1981. This was caused by the announcement, and then execution, of a shift in fiscal policy that was facilitated by massive borrowing from abroad. The dollar appreciation was a necessary factor in that financing, which largely

shielded domestic investment from crowding out. However, a monetary policy oriented to shorter-run stability of exchange rates could prevent short swings in real rates that came from exchange rates moving faster than relative prices. In this sense, a more exchange-rate oriented monetary could provide a smoother path for real exchange rates, but it would not prevent the large swings caused by real events that seem to be labelled "misalignments."

4. The dollar will have to fall below its 1981 level in real terms to bring the trade deficit back to equilibrium. There are two reasons for this. First, when the current account balances returns to roughly zero, it will be composed of a deficit in investment income and services, and a trade surplus necessary to finance the debt service. The exchange rate will have to fall beyond the 1981 level to provide this surplus. Second, during the period of appreciation since 1981, U.S. manufacturing has given up much of the competitive gains it made during the depreciation of the 1970s. The period of appreciation since 1981 has brought new foreign entrants into industries that were previously sources of strength in U.S. trade. While they have a temporary, but protracted, cost advantage over the U.S., they are working down their cost curves, learning and building modern plants. When the dollar returns to its 1981 level, U.S. industry will face a new world of efficient competitors abroad. Expansion will have to come in new sectors, rather than simply re-establishing positions in traditional ones. The dollar will probably have to depreciate in real terms well below the 1981 level to achieve this.

The costs to the economy from this re-adjustment will be substantial. Restoration of the 1981 exchange rate will not put steel or autos or machine tools back in their 1981 competitive position. Why? Foreign competitors have learned the business while they had a cost advantage over the U.S.. They won't forget what they have learned because the dollar depreciates. This means that a new expansion in manufacturing will come in sectors and geographical areas of the economy that are different from those that shrank during the period of appreciation. The skills demanded of labor in the expanding industries will differ from those possessed by labor laid off in the contraction, and they may be industries located far from the "Rust Belt." So the need still exists for micro-level policies that retrain the labor force, encourage mobility and job search, and aid communities in restoring lost tax bases. These are the costs of adjustment to a decade-long swing in the real exchange rate.

5. An across-the-board import surcharge makes sense. While reducing the budget deficit, it would help to bring down interest rates and the dollar. With the appreciation since 1981 raising costs in U.S. manufacturing by over 50 percent relative to major competitors, a 20 or 25 percent import duty would recover less than half the gain bestowed on foreign producers inadvertently by the fiscal shift in 1981. So while it sounds like a heretic deviation from the free-trade position, I endorse a temporary across-the-board surcharge. I append a note by Joan Pearce of Chatham House and myself that outlines the case.

II. Fiscal Policy and the Real Exchange Rate

The shift of fiscal policy that was announced in spring 1981 and executed beginning in 1982 is sufficient to explain the movement in the real exchange rate of the dollar since 1981. The argument is made in "Causes of Appreciation and Volatility of the Dollar;" here I summarize.

The sum of domestic investment and the integrated federal, state, and local government deficit must be financed by the sum of domestic private saving and foreign borrowing. The latter is the current account deficit. With private saving as a fraction of high-employment GNP not responsive to a shift in the deficit, either room for it must be made by a reduction in domestic investment, or it must be financed by an increase in the current account deficit, or a combination of the two. A shift in the "structural" budget deficit of $200 billion, with the ratio of saving to GNP unchanged, requires a combination of reduced domestic investment and increased current account deficit of $200 billion to finance it. This is straightforward economic arithmetic.

What movement in financial markets will generate the needed combination of reduced investment and increased current account surplus? A rise in real interest rates and a real appreciation of the dollar. The latter occurred initially across 1981, as the markets came to understand the deficit implications of the fiscal shift. I note that the argument here is that the _shift_ in the fiscal position required the adjustment. This does not imply that any given _level_ of the deficit is good or bad. But it does imply that calculations that adjust the deficit to make it smaller or larger are irrelevant here. It is the _change_ in the high-employment deficit that counts.

Can the fiscal shift account for the size of the appreciation? Yes. The portion of the shift in the deficit financed by a reduction in the trade balance by 1985 was about $150 billion, or 4 percent of GNP. Rudiger Dornbusch and Jeffrey Frankel, in "Macroeconomics and the Dollar," provide an estimate that a real dollar appreciation of 13.5 percent reduces the trade balance by 1 percent of GNP. [See my "Comment" on Dornbusch and Frankel, enclosed.] So a 4 percent of GNP reduction would require a 54 percent real appreciation. This in the middle of the ball park of estimates of the real appreciation from 1981 to 1985.

Could this have been a sustainable position? No. Eventually international investors were bound to feel that their portfolios were becoming overloaded with dollars. This meant that eventually the dollar would have to depreciate, completing the cycle and shifting the full load of financing the deficit onto domestic investment. This process seems to be underway now, with the dollar depreciating along a path roughly anticipated by the market.

III. The Role of Monetary Policy.

The shift in fiscal policy beginning in 1981 can explain the evolution of the real value of the dollar, but some help is needed from monetary policy to explain movements in interest rates. The story is told in detail in "Expected Fiscal Policy and the Recession of 1982," NBER Working Paper No. 1784 of December 1985, by Arminio Fraga, Robert A. Johnson, and myself.

The co-movement of short-term and long-term interest rates beginning in 1979 is consistent with an unanticipated tightening of monetary policy in 1979-80, followed by an anticipated shift in fiscal policy announced in 1981. Short-term rates first jumped above long-term in 1980. Both rates then fell in the recession, with short rates falling below long rates in the fourth quarter of 1981, and both bottoming as the recovery began at the end of 1982. This pattern of short rates first moving above long rates, then falling below then in recession to a low point as recovery begins, is consistent with the announcement of an expansionary fiscal shift in 1981, preceded by an unannounced tightening of monetary policy to pre-empt the demand effects of the fiscal shift.

More generally, we expect exchange rates to respond quickly to monetary policy, more quickly than the price level. This means that unanticipated shifts in monetary policy will generate sharp fluctuations in the real exchange rate. It also implies that an exchange-rate oriented monetary policy can smooth short fluctuations in real exchange rates that originate elsewhere in the financial sector. To convert this insight into a rule for policy coordination requires an agreement on the effects of fiscal policy.

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The Case for an Import Surcharge

William Branson

Professor of Economics and International Affairs,

Princeton University

Joan Pearce, Head of Policy Studies,

Royal Institute of International Affairs,

London

The Congress is considering protectionist legislation that would focus on particular sectors, such as textiles, or particular countries, like Korea or Brazil. These focused attempts at protection would be distorting and self-defeating. Protection for textiles will simply shift the pressure to another sector; a tariff against Brazil would shift U.S. imports to another supplier. An across-the-board surcharge, viewed as a revenue-raising tax increase, would be much better policy. Support for a surcharge would also come largely from a straightforward protectionist concern to shelter U.S. producers who have suffered a loss in competitiveness because of the strong dollar. Liberal economists can be expected to respond in familiar terms. They will decry the idea as a violation of principles of free trade and evoke the danger of retaliation by trade partners. Retaliation will indeed be threatened, and the administration will use both arguments against the surcharge.

As a general case against import tariffs, especially sectoral ones, these arguments hold water. But against an across-the-board surcharge, they are wrong. The surcharge makes sense, but not for the reasons advanced by many of its proponents. It would reduce the budget deficit .

and bring down interest rates and the over-valued dollar. And for those very reasons, it should not bring about retaliation by Europe or the developing countries.

Let us examine first the economics of the issue. The surcharge is basically a tax increase, since its revenues would be applied to deficit reduction. With U.S. imports running at about $300 billion, the surcharge, if applied across the board, would reduce the Federal deficit by $60 billion. The effect on import spending would be small. Most estimates say that a 20 percent increase in import prices would reduce the quantity of imports by the same less than 20 percent amount, reducing dollar spending on imports.

The reduction in the deficit would lower U.S. interest rates, and this would bring down the dollar. With a smaller deficit, U.S. monetary policy could be eased, further promoting lower interest rates and the depreciation of the dollar. The gains to U.S. industry, farmers, and home buyers should be obvious. The liberal economic opposition to the surcharge is based on thinking of import tariffs as trade policy at the industry level. But the surcharge proposal would have the effect of fiscal policy at the economy-wide level.

Next let's consider the U.S. politics of an import surcharge. It is fundamentally a new kind of tax increase. But it can be sold in the Rust Belt states as a direct attack on U.S. trade problems. Nobody around Pittsburgh will object. And a minimally scrupulous politician could even argue that the tax increase will be paid by the foreigners, who bear the incidence of an import tariff. What better way to reduce the budget deficit?

An import surcharge would inevitably provoke an outcry among the trade partners of the United States. It would be widely seen as the hostile act which its proponents intend it to be. Some would doubtless consider retaliating in kind with a surcharge on their imports from the U.S.. All would condemn the measure as fueling protectionist sentiment and perhaps provoking a trade war which would gravely damage the world economy.

The European Community probably would not reply with a surcharge because of the difficulty of obtaining the agreement of all its member governments. Individual EC governments, particularly France and Italy, might want to impose their own surcharges. The EC as a whole would feel less inhibited about pursuing more aggressively some specific measures detrimental to the U.S., for example, in agricultural trade. It would also be less inclined to cooperate in U.S. moves to initiate a further round of GATT negotiations.

But retaliation would be misguided. The standard objection to retaliation is that if it fails to force a roll-back of the original protection, it only makes matters worse. But in this case there is a further reason to resist the temptation.

The Europeans, and the developing country debtors such as Brazil and Mexico as well, have rightly been complaining about the effects of the strong dollar and high interest rates on their economies. Given the present political situation in the United States, an import surcharge may offer the best prospect of bringing down interest rates and the dollar. True, it would reduce the volume of exports from these countries to the United States, but so too would the depreciation of the dollar that they have been urging. To quell the public indignation which would erupt at a

U.S. import surcharge would probably not be feasible, but policy-makers in other countries would do well to reflect on whether they might gain most by confining their reactions to rehetoric.

Representative HAMILTON. Mr. de Vries, please proceed.

STATEMENT OF RIMMER DE VRIES, SENIOR VICE PRESIDENT, MORGAN GUARANTY TRUST CO.

Mr. DE VRIES. I speak for myself here, not for Morgan Guaranty Trust Co. I will focus on the question of whether the dollar has fallen enough, using these tables to illustrate the different results of four sets of assumptions we used in our model of the U.S. balance of payments. To get our bearings, on a trade-weighted basis we have had almost a 25-percent decline of the dollar from its 1985 peak. It has fallen about 30 to 35 percent against the mark and the yen from February 25, a year ago. With 1980-82 equaling 100, the dollar on a nominal basis still stands at around 110, 10 percent above the average dollar between 1980 and 1982. It is about 6 percent above that level on a real or inflation-adjusted basis.

Has the dollar fallen enough?

Case I assumes no further dollar depreciation, an $18 per barrel oil price this year and next, no change in monetary policy, and a shrinking Federal budget deficit but not to the extent envisioned by Gramm-Rudman. With these assumptions, there is no solution to the problem posed by the current account deficit. The trade balance might fall to about $100 billion before rising again. The current account deficit would still be well above $100 billion throughout the decade. Our debt-to-export ratios would move up to about 150 percent, which certainly approaches the prudent limits of foreign debt. To me this is not a desirable solution, suggesting the dollar has not fallen far enough.

In case II, without any other policy changes, we allow the dollar to depreciate sufficiently to restore trade balance. This requires a collapse of the dollar—an extra 11-percent decline this year and another 20 percent next year. In this case, if the Canadian dollar does not strengthen and remains around 70 cents, the dollar would fall to 100 yen and 1.3 marks. With these exchange rates, startling as they may be, the trade deficit would be eliminated in 2 years.

But as you can imagine, in that type of environment there would be a whopping increase in our wholesale price inflation rate to about 7 percent, without a great deal more growth. Some sectors would benefit, but many others would not, and the net gain for the economy in the United States is uncertain, especially given the adverse terms of trade effects. This scenario would solve our trade and current account problems. However, we would not see a great deal more growth, either here or abroad. I don't like this scenario, particularly because of the very high rate of inflation.

I am afraid of the third scenario in which there is no further dollar depreciation and a U.S. recession. This is, of course, the classical way to deal with balance-of-payments problems—what has been forced on Latin America, Britain, and other countries. A recession cuts economic growth, reduces import demand, and restores balance of payments equilibrium.

This can be done very easily. The United States could implement Gramm-Rudman to the letter and strongly defend the dollar through a drastic tightening of monetary policy in the face of downward market pressures. U.S. growth would turn significantly negative, unemployment would rise to over 15 percent, but the current account deficit would be reduced to more sustainable levels. I do not like this scenario. I don't think the American public would go for it either. Even if some foreigners like it, I don't think we are going to follow that route.

What is the correct strategy? If we could see into the future, we probably could come to an agreement about a course of action.

The course I prefer I call the international growth strategy, illustrated by case IV. I think it is the sensible way to achieve a sustainable current account deficit. We can argue about the level of a sustainable deficit, but I think it need not be zero; if it gets into the $25 billion to $50 billion range, it would be very, very pleasant. Certainly, a deficit of $50 billion is mostly interest payments and can be easily financed. So that is what we should be shooting for.

How to get there? The best way is with a further moderate dollar depreciation on the order of 15 percent in nominal terms. This implies a real depreciation of 10 percent because the U.S. inflation rate would be higher than that of other industrial countries.

But that is only one part. The other part, which is very, very important, is that the Europeans and the Japanese have to aim at an economic growth rate at least 1½ percent higher than what they are projecting today. This is the key: while U.S. growth is around 3 percent for the next couple of years, the Japanese growth moves up to 5 percent, and European into the 4-percent-plus range. I think, considering the tremendous excess savings, budget structures, budget surpluses, excess capacity, and very high European unemployment rates, there is no real excuse in this world for either Japan or Europe to pursue restrictive monetary and fiscal economic policies as they have been.

This policy stance is a legacy of the past, more applicable in the 1970's. But time moves on and it is time to change that stance. With a further modest depreciation of the dollar and a switch in fiscal-monetary policy mix abroad, there will be good growth of the world economy, much more sustainable U.S. trade and current account deficits, and even fairly modest inflation. This is definitely my preferred strategy.

The solution to Latin America and other less developed countries is not plugged in this last scenario. I think, eventually, our trade and current accounts will improve further as we go in the decade and the LDC situation improves. More sustainable growth and more open markets in the LDC's will provide more export opportunities for the United States.

Let me close by making a few remarks about the exchange rate system. Much of the impetus behind raising this issue comes from trying to blame the record U.S. trade deficits on the floating exchange rate system. This reasoning suggests that after reestablishing a better international payments balance, a system of target zones or reference rates should be adopted to preserve that balance.

While reform is worth studying and discussing, I believe that we should approach placing a corset on exchange rates with great caution. A rigid system—and I think we'd probably all agree around this table—is neither viable nor desirable. I would describe such an approach to exchange rate management and the implied need for international policy coordination, as Gramm-Rudman-Hollings approach, in that it puts the cart before the horse.

Let me explain. The task is to develop an exchange rate arrangement that responds to today's realities. The world in which we have lived, and in which I am quite sure we will continue to live, is characterized by very large shocks, both monetary and real as well as huge swings in payments positions. As we go on each balance-of-payments crisis gets bigger than its predecessor.

In the 1960's $1 billion or $2 billion deficits in current account were worrisome. In the early 1970's a current account deficit of less than $6 billion was called a crisis. Then the oil shock produced a non-OPEC deficit of about $68 billion, which disappeared in 3 years and reemerged a year later as a $110 billion imbalance. When that was nearly wiped out, there was the LDC debt crisis, basically a very large balance-of-payments problem—again bigger than the previous OPEC imbalance. And now we have the U.S. imbalance, again exceeding all previous records. And I can assure you, the next imbalance will again be bigger. Be prepared for this.

We are, in fact, today in a historic period. I don't think we have witnessed, in my professional life, at least, a period in which we have seen such enormous changes in market prices—stock markets, bond markets, oil markets, and exchange markets.

What we have witnessed in the last few months as far as the exchange market are concerned a year ago was prophesized as the coming hard landing. And yet today everybody is enjoying it. I guess because most people we know are making money out of this.

Today's reality is frequent and large changes. And they are being reinforced, facilitated, and greased by greatly enhanced capital mobility, fostered by forces defined in such buzz words as deregulation, innovation, securitization, and internationalization.

My first point is those who believe we can establish a U.S. payments equilibrium in the next few years and maintain it by keeping exchange rates in a corset are plainly unrealistic.

My second point is international payments equilibrium may be undesirable. I think all of us around this table would agree—I believe Paul Krugman has referred to this—in the last 4 years the world desperately needed the American imbalance. We needed the U.S. locomotive. With Latin America on its back, Southeast Asia weak, and Europe and Japan unwilling to grow more rapidly, an attempt by the United States to shoot for a trade and current account balance would have produced the deepest recession and most explosive debt crisis ever.

We needed an imbalance. And it was consistent for us to run a large deficit, as the rest of the world wanted to run surpluses. However, there is a time for everything, and a time limit on how long we should run huge budget and trade deficits.

The time has come. We have played our role. Now we must begin to make changes for we cannot finance these huge deficits forever. Everyone has to make changes. But you see the difficulties, as I think Rudi Dornbusch has said and everyone agrees. We cannot change the German policies. They have made a fetish out of the external surplus, and so have the Japanese. There will be no policy changes abroad this year. The irony is that what the politicians are unwilling to change, markets will change for them.

A growth impetus is now coming from lower oil prices. Total oil demand has not picked up because of the low rate of growth of the world economy. With oil production picking up elsewhere, eventually Saudi Arabia had to change its export policy. They couldn't hold off any longer. We are now in the midst of a declining oil price, and it has not run its course. I honestly feel we are going to be lucky to keep an average of $18, as I have assumed.

The decline in oil prices is giving a more positive growth impulse to Europe and Japan than to the United States. At the same time it is contributing to the decline of the dollar. Both declines will rapidly push inflation in Japan and Europe toward zero. This eventually will force them to lower interest rates, which in turn will give them the economic stimulus that we have been advocating for some time.

I am all in favor of searching for an international monetary system assuring more consistent economic policies among countries. I would, however, like to emphasize recent history, which teaches us that major governments are far less concerned with international economic policy coordination than with domestic policy issues and prerogatives. We should remember that the Bretton Woods system failed precisely because there was no mechanism by which surplus countries could be forced to adjust their policies, and the United States was unwilling to alter its policies to preserve exchange rates.

I would like to advocate keeping the horse before the cart: not create a target zone system in the immediate future, but rather make an earnest attempt to help the current system function more smoothly. This can be done through the G5 or an expanded G7, perhaps with the inclusion of the managing director of the Fund.

Such discussions backed occasionally by credible threats of trade sanctions, might produce the needed policy changes for sustaining satisfactory economic growth while correcting payments imbalances and preserving flexibility to deal with inevitable shocks.

Thank you.

[The prepared statement of Mr. de Vries follows:]

PREPARED STATEMENT OF RIMMER DE VRIES

The dollar and the exchange rate system

Adding to the developing momentum for overhaul of the exchange rate system, the past month's spectacular declines in both the dollar and oil prices make today's roundtable discussion particularly timely. It is my privilege to participate from the personal perspective of a commercial bank economist. I should perhaps note that I do not pretend to offer my own institution's formal views on the issues at hand.

In the eyes of most businessmen and politicians, depreciation of the dollar promises the obvious quick-fix solution for the trade deficit. The dollar has, in fact, come down over 25% on a nominal effective basis from its short-lived peak almost twelve months ago – and by substantially more against the yen and the mark. That should ensure that, following a likely run of poor figures this winter, the trade deficit should wind up about the same or a little less than 1985's $148 billion (CIF valuation) – and well below the $170 billion annual rate of 1985's fourth quarter. However, at present the dollar still stands almost 10% higher on average than during the first three years of this decade and more than 25% above its all-time low back in 1978. Moreover, it should be borne in mind that U.S. inflation, while subdued the past several years, far outpaced rates of price increase in our principal trading partners during the late 1970s and early 1980s. Accordingly, the competitive position of U.S. agriculture and much of U.S. industry continues under pressure.

My initial points address the question of whether the dollar must fall still further. I emphasize the need for a more comprehensive international strategy in which world economic growth is encouraged even as the U.S. trade imbalance is corrected. I then offer brief remarks on the feasibility and relevance of reforming the exchange rate system.

Must the dollar fall further?

How much further the dollar must fall in the interest of substantial reduction of the U.S. trade and current account deficits cannot be judged in isolation from the implications of depreciation for U.S. inflation and the potential for macroeconomic policy changes both in this country and in Japan and Europe. Nor can the future of Latin America and the other developing countries be left out of the picture. The trade-offs at stake are best examined through scenario analysis. Summary quantitative results are presented in the tables at the end of this paper. It should go without saying that the figures are to be interpreted less as literally predictive than for illustrative value.

Case I: It is worth exploring in some detail the likely course of the U.S. trade deficit and global economic performance in the event that no further depreciation of the dollar occurs below its present level and no fresh policies are implemented — here or abroad — for the express purpose of narrowing the U.S. imbalance.

We share the widely-held belief that the recent fall in oil prices — assumed here to stabilize at $18 per barrel for the next couple of years, gradually recovering later to $26 by the end of the decade — will boost economic growth in the major industrial countries this year and next relative to the sluggish path foreseen prior to the actual fall in oil prices. The growth boost is not a certainty. It should be positive unless policymakers are extraordinarily perverse in their responses to the price drop or — as we do not judge probable — there are major casualties among oil producers and financial institutions. The benefit to economic growth should accrue more to Japan and Europe, as large oil importers, than to the United States — a perception that may help explain the dollar's 5% tumble in exchange markets in the past five weeks alone. Following some setback in 1987, stemming partly from reduced export competitiveness, economic growth in Japan and Europe should inch upward later in the decade as the drag from their currency appreciations dies out. By contrast, the medium-term U.S. growth outlook is far from inspiring: there will be a chronic net contractionary impulse from budget deficit reduction. Even if the cuts fall short of Gramm-Rudman targets, their contractionary impact likely will not be offset fully by monetary policy. As a result, U.S. unemployment is unlikely to come down materially below the present level and could trend moderately higher in future years. Some comfort may be taken from the prospect that U.S. inflation then would stay fairly restrained, at least by the standards of the 1970s if not by those maintained at present.

Unhappily, this scenario fails to support a sustained reduction in the U.S. trade deficit. The deficit would come down for a time, but bottom out above $100 billion per annum, CIF basis, before rising to the present level or even higher by the end of the decade. The initial shrinkage would be driven by the lower oil price and real exchange rate that now prevail. Later in the decade, both factors would work in reverse, assuming oil prices indeed recover and an adverse U.S. inflation differential undercuts competitiveness.

Still less encouraging is the outlook on current account. The accumulating deficits that already have made the United States a net debtor to the world will engender steeply-rising net interest payments to foreigners. The current account deficit may not shrink at all below last year's level and could approach an outsize $170 billion by 1990. At nearly 4% of U.S. GNP, versus 3% at present, that would be a monumental gap in U.S. terms and a formidable call on foreign savings. Would the latter be forthcoming? Many doubt it, since by that time the U.S. net debt position, relative to export earnings, would be heading fast into the zone that in the past has typically triggered financing problems, at least in other countries. Moreover, the advent of a new Administration after the 1988 elections will bring uncertainty about the subsequent thrust of U.S. policies.

Case II: The outlook just described plainly fails to satisfy the U.S. Administration. Several of its members are calling for distinctly greater depreciation of the dollar than has yet occurred. It is natural to ask how big a depreciation is required to wipe out the deficit entirely, again in the absence of policy changes. The second scenario shows that objective to be roughly achievable as early as 1988, provided the dollar this year averages about 25% lower than in 1985 (consistent with an immediate and sustained drop of about 11% from the present level) and then is lowered by a further 20% on average for 1987. Unless the Canadian dollar were to recover strongly, such an overall depreciation of the U.S. currency could entail a yen rate of not much more than 100 to the dollar next year, along with a mark rate of 1.30 or so. Rates of this order are, to say the least, startling from today's perspective.

No less startling, particularly to proponents of a devaluation strategy, should be the growth and inflation implications. Although the export and import-competing sectors of the U.S. economy would gain in terms of production, profitability, and jobs, there would be negative consequences on each count elsewhere in the economy – notably in construction and services, which contribute much more to GNP and overall employment than do agriculture and manufacturing. The negative consequences would stem not just from ongoing budget cuts but also from the real income and purchasing power losses in the nontradables sector occasioned by the nation's worsened terms of trade. These mean that the net benefits of dollar depreciation to GNP and jobs economy-wide may be only mildly positive. The adverse inflationary consequences from depreciation are more certain. In the space of just two years, U.S. wholesale prices could be rising five percentage points per annum faster than today, in all probability launching a vicious new wage-price spiral that would undo the hard-won progress of the last five years. Interest rates almost surely would have to rise, whether through market forces or Federal Reserve restraint.

The conclusion must be that elimination of the trade deficit solely through dollar depreciation would deliver next to nothing of the benefits to U.S. economic growth and employment that have been so often proclaimed – and at the incalculable cost of a quantum leap in inflation.

Case III: Domestic recession is the classical alternative to currency depreciation as a means to curb trade deficits. It is never a popular remedy, whether in Britain or southern Europe during the 1960s and 1970s, or in Latin America during the past three years. The third scenario indicates just how nasty the medicine would be were the United States to undergo recession of sufficient severity and duration to eliminate the bulk of the trade deficit with no further change in the dollar. Gramm-Rudman budget cuts could themselves go far to precipitate such a recession. Misguided steps to defend the currency could magnify the risk. In this connection the speed of the dollar's decline during recent weeks not only has come as a surprise to exchange market observers generally but also has raised anxiety levels at the Federal Reserve. Chairman Volcker now is on record in opposition to further depreciation at this time. To defend the dollar, an increase in U.S. interest rates – in real, if not in nominal terms – may prove necessary.

Recession then could follow. On the implausible assumption that foreign countries would take effective preventive measures to avoid catching pneumonia along the way – past experience gives little encouragement on this score – it would require two successive years of 3% annual contraction in U.S. real GNP, starting in 1987 and giving way later to minimal growth, to get the trade figures back close to balance. U.S. inflation would be virtually nonexistent. However, that would be scant basis for celebration, since the unemployment rate would have to surge upwards of 15%. Some European countries currently endure unemployment rates of that order, as did the United States

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during the Great Depression. Whether the U.S. body politic would stomach such figures today must be judged questionable.

Case IV: Recession works to improve the trade balance insofar as U.S. economic growth falls sufficiently below growth elsewhere in the world economy. It is the difference in growth rates that counts for the direction of the trade figures. Thus, the grim results of the recession approach carry a constructive and timely message: the faster the growth of foreign economies, the less the need for dollar depreciation, U.S. recession, or some combination of the two.

The fourth scenario shows that, in conjunction with further moderate dollar depreciation, a feasible step-up in foreign growth can contribute mightily to correction of the U.S. trade and current account deficits. Specifically, the objective of shrinking these deficits to manageable magnitudes, of $40 billion or less, is met by foreign economic growth that proceeds on a sustained basis about 1.5 percentage points per annum faster than present policies seems likely to deliver. Is such a step-up genuinely feasible? Many foreign officials would shrink from the implied shift demanded in their existing policy positions and commitments. Thus, in both Japan and Europe, governments remain hamstrung by fiscal policy commitments born of their follies of the 1970s. Those commitments now are inappropriate, in fact harmful, amid today's quite different realities and needs.

Japan's fiscal policies continue to penalize domestic consumption, private and public, notwithstanding that nation's bloated trade surplus and vulnerability to U.S. and European protectionism. There is growing recognition within Japan of the need for change, but for now the official strategy relies on protracted study to defer decisive action.

European governments have little leeway for independent fiscal action, given Germany's rigid adherence to fiscal "rectitude." Yet, all across Europe, massive unemployment constitutes not only grand-scale waste of people's lives but also prima facie evidence of underutilization of resources. Europe's substandard economic recovery depended disproportionately on the stimulus of exports to the United States. That stimulus is now beginning to reverse, and must go further in reverse as the U.S. trade imbalance is corrected. For now and the year ahead, Europe may bask complacently in the glow of lower oil prices. However, stimulus from this source is substantially a one-shot affair.

Thus, if it is not here already, the time is fast ripening for overhaul of Japanese and European – especially German – economic policies. At the macroeconomic level the overhaul should emphasize tax cuts without obsessive concern for fiscal deficits. At the micro level, the emphasis needs to be on deregulation and labor market reforms so that real domestic demand can be stepped up without imperiling Europe's gains against inflation.

Finally, there is the long-term challenge of restoring adequate economic growth in the developing countries, especially the debt-burdened Latin American nations. Five years ago the United States ran a $6 billion trade surplus with non-OPEC Latin America; by 1985 that surplus had become a deficit of $13 billion. Once normalization of financial flows is achieved, there is scope for considerable improvement of the U.S. trade position.

In the wake of the debt crisis, Latin America's people have suffered serious erosion of living standards and ability to purchase U.S. exports. Their prospects for swift recovery are slim unless the industrial countries themselves grow faster, expanding and opening their markets for LDC exports. Equally important, the debtor countries must launch a determined drive for market-opening, growth-oriented reforms of their domestic economies. These needs were correctly identified in Treasury Secretary Baker's initiative last fall. In view of Mexico's new problems, however, some have suggested that the Secretary's initiative now is "dead before arrival." That grossly misreads Mexico's fundamental needs for structural improvement. They will take considerable time to work out – probably the rest of the decade at least. However, if they can be executed successfully in Mexico, while the other countries of Latin America also get back on track for growth, the region can once again become a flourishing market for U.S. exports, at the same time helping to balance the overall U.S. trade and current accounts.

The exchange rate system

Let me close by making a few remarks about the exchange rate system and the question of international monetary reform. Much of the impetus for reform arises from the tendency to blame the sharp swings in exchange rates and the record U.S. trade deficit on the floating exchange rate system. Acceptance of such reasoning suggests that, after reestablishing a better international payments balance, a system of target zones or reference rates should be adopted to preserve that balance. While reform is worth studying and discussing, I believe that we should approach placing a corset on exchange rates with great caution. A rigid system is neither viable nor desirable. Such an approach to exchange rate management and the implied need for international policy coordination could be described as a Gramm-Rudman-Hollings approach in that it puts the cart before the horse.

Let me explain. First, the task in front of us is to develop an exchange rate arrangement which responds to the needs and realities of today's world. The world in which we have lived, and in which I am quite sure we will continue to live, is one characterized by large real and monetary shocks and huge swings in payments positions. Every balance of payments crisis seems to be bigger or more serious than its predecessor. In the early 1970s a current account deficit of less than $6 billion was called a crisis. Then came the $68 billion surplus of OPEC countries in 1974, which disappeared by 1979 but exploded again to $110 billion in 1980. Next came the LDC debt crisis which in large respect was another balance of payments crisis, again bigger than the OPEC imbalance. Now we have a U.S. imbalance exceeding all previous records. Again, we are witnessing historical gyrations: long-term interest rates have fallen 5%-6% since 1982; oil prices are down 50% from the peak level (one-half of which has occurred this year); and the exchange rate of the dollar is down over 25% from its peak of a year ago. This last event especially once was prophesied as "the coming hard landing," but everybody seems to be enjoying it.

Today's reality is that we are living in a world of frequent and large changes, which are reinforced and facilitated by greatly enhanced capital mobility, fostered by deregulation, innovation, securitization, and internationalization. Those who believe that we can establish international payments equilibrium in the next few years and then maintain it by keeping exchange rates in a corset are unrealistic.

Moreover, it is clear that an international payments equilibrium is not even desirable. In the last four years the world desperately needed the U.S. locomotive. The rest of the world had excess savings and, if we had run a current account balance, a world depression would have ensued. Of course, there is a limit on how long such imbalances can persist: there has to be a timely correction. Unfortunately, as pointed out earlier, there has been no willingness abroad to adopt policies that would be <u>consistent</u> with a contraction of the U.S. current account deficit, even now that the U.S. budget deficit is on the mend. The irony is that if policymakers do not want to change, markets will do it for them. One result of the low growth in industrial economies — in turn the result of contractionary policies pursued in Europe and Japan — is that it held back oil demand to the point that Saudi Arabia had to change its policies by stepping up its oil production. The consequent reverse oil price shock will benefit growth in foreign industrial economies more than the United States and this appears to be contributing to the dollar's decline. Moreover, the decline of oil prices and the dollar will produce virtually zero inflation in Germany and Japan. Thus, Germany and Japan can afford to adopt a more stimulative policy, which would strengthen the temporary boost to real growth coming from the oil price decline. Accordingly, the dynamics of markets will do what politicians have refused to do.

Finally, I am all in favor of searching for a system which can assure the world of more consistent economic policies. However, we should remember that the Bretton Woods system failed precisely because there was no mechanism by which surplus countries could be forced to adjust their policies and the United States – at the time in deficit – was unwilling to alter its policy in order to preserve exchange rates. Recent history again teaches us that major governments are far less concerned with international economic policy coordination than with domestic policy issues and prerogatives. What I would like to advocate is not to put the cart before the horse by creating a target zone system, but rather to make an earnest attempt to use the G-5 or G-7, perhaps with the inclusion of the IMF's managing director, to make the current system function more smoothly. Discussions in such fora, backed occasionally by credible threats of trade policy actions and sanctions, might produce the policy changes needed to produce satisfactory economic growth and sustainable payments balances, while preserving flexibility to deal with inevitable shocks.

Dollar exchange rates
units per dollar, except as noted

	Feb 20, 1986	% changes since Feb 25, 1985	Sep 20, 1985	Jan 17, 1986
Nominal effective	109.6*	-22.2	-12.9	-5.1
Real effective	105.6*	-21.7	-11.7	-4.8
Dollar vis-a-vis				
Japanese yen	180.95	-31.1	-24.6	-10.6
German mark	2.31	-33.0	-18.7	-6.1
French franc	7.08	-32.9	-18.3	-6.3
British pound**	1.45	-37.4	-5.9	-0.9
Italian lira	1568.5	-27.3	-18.1	-6.6
Canadian dollar	1.39	-0.9	1.0	-0.8

*1980-82=100.
**Dollars per pound.

Case I: No dollar depreciation or policy changes
percent changes, except as noted

	1985	1986	1987	1988	1989	1990
U.S. trade balance, CIF ($ bil.)	-148	-136	-120	-105	-119	-142
Exports ($ bil.)	213	232	255	272	284	296
Imports ($ bil.)	-362	-368	-376	-377	-402	-437
Current account ($ bil.)	-123	-137	-128	-121	-138	-167
Foreign liabilities, net of assets ($ bil.)	93	230	358	479	617	784
Net debt-export ratio (%)	9	43	73	100	126	155
Effective dollar (1980-82=100)						
Nominal	127	110	109	109	109	109
Real	121	108	107	108	110	113
6-month U.S. Treasury bill (%)	8.4	6.8	6.2	6.5	6.3	6.1
U.S. wholesale prices	2.3	0.9	1.1	2.6	4.2	4.6
Foreign prices (traded goods)*	2.3	-1.3	1.2	1.5	1.9	1.9
U.S. real GNP	2.4	3.3	3.0	2.5	1.9	2.4
Domestic demand	2.9	2.7	2.7	2.2	1.9	2.5
Unemployment rate (%)	7.1	6.7	6.6	6.8	7.5	7.7
Foreign real GNP*	2.9	3.2	2.7	2.9	3.1	3.3
Japan	4.2	3.2	3.0	3.5	3.8	4.0
Europe	2.2	3.1	2.5	2.6	2.8	3.0

*OECD countries other than the United States.

Case II: Dollar collapse
percent changes, except as noted

	1985	1986	1987	1988	1989	1990
U.S. trade balance, CIF ($ bil.)	-148	-127	-64	-7	-3	-23
Exports ($ bil.)	213	245	320	364	386	412
Imports ($ bil.)	-362	-372	-384	-371	-389	-435
Current account ($ bil.)	-123	-131	-81	-26	-19	-37
Foreign liabilities, net of assets ($ bil.)	93	224	305	332	350	388
Net debt-export ratio (%)	9	41	56	61	62	63
Effective dollar (1980-82=100)						
Nominal	127	100	80	78	76	73
Real	121	101	85	87	89	91
6-month U.S. Treasury bill (%)	8.4	7.5	8.3	8.7	8.0	7.8
U.S. wholesale prices	2.3	1.7	4.6	6.7	6.7	6.4
Foreign prices (traded goods)*	2.3	-2.3	0.3	1.0	1.3	1.3
U.S. real GNP	2.4	3.2	3.0	2.8	2.3	2.5
Domestic demand	2.9	2.5	1.9	1.8	2.0	2.5
Unemployment rate (%)	7.1	6.8	6.7	6.7	7.0	7.3
Foreign real GNP*	2.9	3.2	2.7	2.9	3.1	3.3
Japan	4.2	3.2	3.0	3.5	3.8	4.0
Europe	2.2	3.1	2.5	2.6	2.8	3.0

*OECD countries other than the United States.

Case III: U.S. recession with no dollar depreciation
percent changes, except as noted

	1985	1986	1987	1988	1989	1990
U.S. trade balance, CIF ($ bil.)	-148	-136	-94	-45	-30	-22
Exports ($ bil.)	213	232	255	273	289	305
Imports ($ bil.)	-362	-368	-349	-317	-319	-327
Current account ($ bil.)	-123	-137	-100	-51	-32	-18
Foreign liabilities, net of assets ($ bil.)	93	230	330	381	413	431
Net debt-export ratio (%)	9	43	70	85	91	93
Effective dollar (1980-82=100)						
Nominal	127	110	109	109	109	109
Real	121	108	105	104	103	102
6-month U.S. Treasury bill (%)	8.4	6.8	7.5	7.5	6.4	5.3
U.S. wholesale prices	2.3	0.9	-0.2	0.1	1.2	1.3
Foreign prices (traded goods)*	2.3	-1.3	1.2	1.5	1.9	1.9
U.S. real GNP	2.4	3.3	-3.3	-2.8	0.8	1.0
Domestic demand	2.9	2.7	-3.7	-3.5	0.5	0.7
Unemployment rate (%)	7.1	6.7	11.0	14.9	16.3	17.6
Foreign real GNP*	2.9	3.2	2.7	2.9	3.1	3.3
Japan	4.2	3.2	3.0	3.5	3.8	4.0
Europe	2.2	3.1	2.5	2.6	2.8	3.0

*OECD countries other than the United States.

Case IV: An international growth strategy
percent changes, except as noted

	1985	1986	1987	1988	1989	1990
U.S. trade balance, CIF ($ bil.)	-148	-126	-82	-40	-32	-34
Exports ($ bil.)	213	247	297	336	372	412
Imports ($ bil.)	-362	-373	-380	-376	-404	-446
Current account ($ bil.)	-123	-129	-94	-51	-41	-40
Foreign liabilities, net of assets ($ bil.)	93	222	316	367	408	448
Net debt-export ratio (%)	9	40	60	69	72	73
Effective dollar (1980-82=100)						
Nominal	127	102	94	92	90	88
Real	121	100	95	95	96	96
6-month U.S. Treasury bill (%)	8.4	7.6	7.9	7.2	7.0	6.8
U.S. wholesale prices	2.3	1.8	3.3	4.8	6.0	6.4
Foreign prices (traded goods)*	2.3	-0.7	1.0	2.7	3.2	3.6
U.S. real GNP	2.4	3.2	3.1	2.8	2.1	2.6
Domestic demand	2.9	2.5	2.3	2.0	1.8	2.3
Unemployment rate (%)	7.1	6.8	6.6	6.6	7.1	7.2
Foreign real GNP*	2.9	3.6	4.2	4.3	4.5	4.5
Japan	4.2	3.7	4.5	4.8	5.0	5.0
Europe	2.2	3.6	4.0	4.1	4.2	4.2

*OECD countries other than the United States.

Representative HAMILTON. OK, gentlemen, thank you very much. I think the way I would like to begin is just to let you comment on the statements your colleagues have made with which you agree or disagree. Obviously, there are differences among you.

So let's open it for a few minutes for discussion.

Mr. Cooper.

Mr. COOPER. I think, as Rimmer de Vries has already said, that there is a very high degree of agreement among us, that once one clears away the question of baselines and some semantic issues, I suspect you will find us all basically in the same ballpark.

There is only one really bad idea that has been put forward this morning, and that is Bill Branson's suggestion for an across-the-board import surcharge of 20 to 25 percent.

I would like to give the reasons why I think that that is a terrible idea. And then I have a comment clarifying the semantics on Dornbusch's view about the need to coordinate policy.

I think the import surcharge is a thoroughly bad idea for several reasons.

First, it would violate international agreements, and the consequence of that by the United States would be to release other countries from their similar agreements, and I think that you would find such a surcharge widely emulated. I use the word "emulation" deliberately rather than "retaliation," because I am not sure there would be much tit-for-tat motivation behind it. But once it became respectable to ignore GATT bindings, then I think you find many countries in today's world that would raise their tariffs, including Europe in this regard.

So you will find it widely emulated, leading to a world of higher tariffs.

Second, once it was imposed, I think we would have a terrible time getting it off. We know how difficult it is to find new sources of revenue. It would be very difficult to get it off. I suspect the only way to get it off would be to negotiate reductions as, indeed, we have been doing for the last 40 years. It would take another 10–20 years to get the import surcharge off again through international negotiations.

I can't think of any single action by the United States—I come to the third point—that would be such a sharp slap in the face to the debtor countries around the world.

We are just squeaking our way by the international debt problem now. There is some question whether we will succeed in avoiding its becoming a major financial crisis. As Rimmer de Vries has said, the strength of the U.S. economy during the last several years has been such salvation as there has been for a number of the debtor countries.

For the United States to visibly, politically, psychologically close its markets to the debtor countries would convert into action the arguments that are now being made in Brazil and Mexico—we've seen it in Peru—of those who say they should not pay these debts.

That could, in turn, precipitate the kind of international financial crisis that was precipitated in 1931, and which, incidentally, also followed a major tariff increase by the United States in the Smoot-Hawley tariff of 1930, and which so far we have avoided.

Fourth, it is worth pointing out that an import surcharge, while it would help all of those that compete with imports in the first instance, would end up hurting our exporters, the really strong parts of the U.S. economy. The high-technology part, and the farmers, and so forth would be hurt because there would be some compensatory adjustment in the exchange rate. The dollar would fall less than it otherwise would, or possibly even rise under these circumstances. So we would be hurting parts of the economy that we would not want to hurt. Also, costs would be increased for those producers—which now includes many of them—that use imported inputs or materials in competition with imports.

For all of these reasons, I think that this is a terrible idea. Now, in putting this idea forward, Bill Branson has emphasized the fiscal aspect rather than the trade policy aspect, the fact that it would be a source of revenue in a period in which we need to reduce the budget deficit.

I agree with that. But emphasizing the fiscal aspect suggests that we ought to look at alternative, far less damaging sources of revenue than a surcharge on imports.

Representative HAMILTON. OK. I don't want to turn this thing into a debate today on an import surcharge but, Mr. Branson, you've been vigorously attacked here by Mr. Cooper. We'll give you time to respond.

Mr. Krugman wanted to make a comment. I take it, Mr. Branson is the only one that favors the import surcharge. We don't want to gang up on him too much, but, Mr. Krugman, you go ahead with your observation.

Mr. KRUGMAN. I did want to say something negative about that. Let me hold off.

Representative HAMILTON. No, that's all right. Go ahead.

Mr. KRUGMAN. Before I comment on that, I just wanted to discuss one other thing. We have been talking about baselines and I guess the question of how much dollar decline is enough is, in some sense, a technical problem.

But I do want to mention that we keep on referring back to the real exchange rates as of 1978–80 or thereabouts as some kind of reference point. Now while this is a useful exercise, a lot of water has passed under the bridge since the late 1970's. Bill Branson has quite correctly emphasized the water that's been pushed under the bridge by the fact that the dollar has been strong during the interim period.

But it's also the case that, even without the strong dollar, there would have been a lot of changes. And what I have in mind in particular is the pace of change in the structure of the Japanese economy.

Japan has a very high rate of productivity growth, which is very much concentrated in the manufacturing sector, as opposed to its relatively lagging services and, in general, nontraded sectors.

That means that if you use a real exchange rate, which measures prices in Japan by an economywide average, it can be extremely misleading.

Richard Marston of the University of Pennsylvania recently did a calculation where he took the conventional measure of the real exchange rate change of the yen against the dollar from 1973–83, which turns out to be roughly zero, and then measured the real exchange rate change on an appropriate concept for the competitiveness of the manufacturing sectors of the two countries, which is really what we're interested in. He found out that where it mattered the dollar had over that period in real terms appreciated by 40 percent against the yen.

In other words, using conventional real exchange indicators gives you a bias of about 4 percent per year. So if you think that the yen was about right at 220 in 1980, and you want to adjust the change in the exchange rate since then by both the difference in inflation rates, which has been lower in Japan, and this productivity effect on Japan, you would now think that the right value of the yen is around 165.

So you have to be very careful about making those real exchange rate calculations. And that's one reason why I believe there's still a fair ways down for the dollar to go.

OK, that's a technical but important point. Now let me criticize my colleagues. I think there's one and a half bad ideas here, not just one bad idea. And the justice is that the half-bad idea comes from Dick Cooper, who says that we should be pushing for a monetary expansion right away.

That depends very much on how certain you are that Gramm-Rudman——

Representative HAMILTON. Is that the one or the half?

Mr. KRUGMAN. That's the half.

Representative HAMILTON. All right.

Mr. KRUGMAN. It's not quite as bad an idea as the import surcharge.

Representative HAMILTON. All right. OK.

Mr. KRUGMAN. But it's a bad idea all the same.

How certain are we that Gramm-Rudman is really going to happen? And how certain are we that, to the extent it does happen, it's going to be done for real and not with mirrors, by things like the selling off of Government assets?

If you're not dead sure of that, then you can have a rather nasty scenario. Suppose that the Federal Reserve pushes down interest rates and pushes down the dollar now?

We have right now a recovery which is going along at a pretty acceptable pace before we have felt any of the favorable trade balance effects of the declining dollar, and before we've reduced interest rates any further.

Add to that Rudi Dornbusch's swing from the value of the dollar—I don't believe the trade deficit would strengthen from 2.5 to 1, but suppose it did—plus some impact of lower interest rates.

Then we're looking toward an economy 2 years from now which is overheating on the demand side at the same time that, sooner or later, the decline of the dollar begins to give us higher prices from the import side.

Surely at that point we would be running a substantial inflation risk. What would happen in that case?

Well, what would happen is that the Federal Reserve would truly not allow that to happen and they would pull in, rein back, and the dollar would go bouncing up again.

It's even possible—I would say even somewhat likely—that if the Federal Reserve stays put, does not push the dollar down further, that if we don't get action, real action, on the deficit over the next 2 years, that we're going to see interest rates having to rise and the dollar bouncing up.

That's what I meant earlier in saying that the dollar has probably overshot unless we do get real action on fiscal policy.

Now what could make this a really bad scenario would be if we did something like what Bill Branson wants. Suppose that we really do get deficit reduction, but the way we do it is by slapping on an indirect tax—either an import surcharge or something like the value-added tax. A value-added tax is a disguised sales tax. I guess, if we do it, we'll disguise the disguise by calling a value-added tax a business transfer tax.

But, anyway, suppose we do something which amounts to a nationwide sales tax, which gives us a nice, big inflationary push directly from taxes at the same time that we're precipitating a fall on the dollar, which is eventually desirable. But, the two effects combine to give us a really nice inflationary push.

What happens then is that the Federal Reserve reins in and we manage to have stagflation back all over again. So I think that the combined ideas of Dick Cooper and Bill Branson could set us up for a nasty scenario.

Representative HAMILTON. It's like more than one and a half the way you describe it.

Mr. Branson, do you want to respond to some of these charges against your proposal before we go on to some other things?

Incidentally, I want to pick up Mr. Cooper's idea about areas of agreement among you. I want that spelled out for me more carefully. But I want to give you some time here on this surcharge.

Mr. BRANSON. Sure. Maybe Rudi Dornbusch wants to add to—do you want to object any more than Dick Cooper objected?

Mr. DORNBUSCH. I think there is an aspect that Rimmer has brought up, that threatening trade action often brings out the best in other people if we can afford it in a way that doesn't turn nasty. I think that threatening Japan with trade action has moved the yen very effectively, whether it is by capital controls there or appeal to the ancestors. It certainly has worked.

I think it has generated overtones that maybe have been undesirable, but I doubt that there would have been any other measure that could have just effectively moved the yen.

Actually having to do it, of course, is very undesirable and I agree with what Dick Cooper and Paul Krugman have said, that it's not a good mark for a policy and you really can't be so certain that, in fact, the costs of it in terms of the inflationary impact, the incidence on exports, aren't extremely high.

So I would certainly be opposed to actually doing it.

Representative HAMILTON. Mr. Branson.

Mr. BRANSON. OK. Well, let me speak about that directly and then the point about areas in agreement.

I think of this idea of an import surcharge as a second-best fiscal policy. I think revenue raising is necessary and this is a bad way to do it, but it's a way to do it.

Clearly, I think that it would be preferrable to raise revenue by normal means, but I think that this is an alternative that should be seriously considered.

I mean, the arguments that Dick Cooper makes, I just think are overdrawn. I think, on the emulation point, I think that overemphasizes the position of the United States in the world economy. The United States is no longer the leader who sets the tone.

And to tie U.S. policy by making an argument that says: If we do this, somebody else will follow our lead, I think is overemphasizing the U.S. position.

I think the way to get an import surcharge off would be to make it temporary. I think that there may be a "crisis" in terms of debt coming, independently of whether or not we put on an import surcharge. And, in fact, sometimes I wonder why it is that we would necessarily oppose Latin American debt repudiation in the first place.

So the weight of an argument that says Latin American debt repudiation is a bad thing and would be precipitated by putting on an import surcharge I think is lessened by some fundamental questions about whether it would be a bad thing in the first place.

I don't agree that an import surcharge would hurt exporters. I think that reasoning comes from a line of traditional thinking about trade theory that says: "When you impose a tariff, you give back the revenue in order to have a zero fiscal effect."

And of course you get a real appreciation and it's bad for exporters. I'm proposing that we consider seriously a tariff as a revenue-raising measure, and I think that would cause the dollar to depreciate, giving the effects that Paul Krugman suggests on the price level, of course.

So I think I agree with the last point that Dick Cooper made, that there are better ways to raise revenue.

Representative HAMILTON. What are they?

Mr. BRANSON. I'd go, as opposed to Paul Krugman, I'd go for consumption value-added taxes. And I'd use Dick Cooper's argument that says that if you explain this clearly, that there's a once for all change in the price level when you put in a significant tax of that sort.

Then at least the Federal Reserve ought to be able to understand that. So the argument that the Federal Reserve would have to react by tightening because the price index goes up by 7 percent one year when you put in a value added tax, I don't think is—one ought to be able to at least explain that to the Fed.

Representative HAMILTON. I was interested in your observation a moment ago that you don't think the United States is any longer the leader in the world economy. This is a bit of a surprise to me.

Mr. BRANSON. Well, I think that there's been a trend in the U.S. position in the world economy that essentially started from what I think of as a false position.

After World War II, the United States was dominant in manufacturing almost by default. And that was a position that simply was not sustainable. And there are lots of attitudes, institutions—IMF, GATT, and World Bank—formed in an atmosphere in which the United States was essentially calling the tune, with two or three other major players.

Representative HAMILTON. Aren't we still the principal actor though in economic affairs?

Mr. BRANSON. I think of the United States as being one of roughly three equals—Europe and Japan being the other two—as opposed to being dominant. And I think that the thinking about foreign policy, foreign economic policy, ought to adjust to that.

Representative HAMILTON. Let's spell out some of these areas there is agreement for us on these exchange rate questions, on the dollar and so forth.

I noticed, it seemed to me in listening to your discussion, for example, on the area of whether or not the dollar ought to go down. But, you, Mr. Dornbusch, were kind of by yourself. Everybody thought the dollar ought to come down.

I may not have understood you completely or correctly, but I have the impression in your remarks that you really thought the dollar should not come down any further.

Mr. DORNBUSCH. Yes, I had.

Representative HAMILTON. That's a difference, isn't it? There certainly seems to be a general disagreement. I don't know anybody that spoke up for this target zone idea in exchange rates. Nobody was advocating a major international conference on exchange rate reform, that I recall.

Were you? You were not.

Mr. COOPER. I was advocating formal official discussion of these various proposals. My forecast is that they will not mature in the adoption of any of them though.

Representative HAMILTON. But let's spell out some of the areas of agreement among you and make clear, to me at least, some of the differences.

Mr. DORNBUSCH. I had planned to ask two questions. One is on this issue: Must the dollar decline further?

My argument is to look at what determines U.S. net exports and, of course, there may be differences in the equations people have.

I estimated some and asked—even with the lags with which changes in the dollar affect the trade balance—what can we expect will be the U.S. current account over the next 2 years, taking into account all the dollar depreciation that has occurred until December?

But assuming that we and the rest of the world grow at the same rate and that the real price of oil is what it was in December, not the good news we have now.

On that basis, I have the net exports coming down from 2.5 percent of GNP to something between 1 and 1.5. How much exactly will depend how you do your equation.

So there is a lot of uncertainty. Half a percent of GNP worth of it. But it goes very far.

Then the question is the next bit: Do you want to adjust that with aggressive dollar depreciation? Or should you try and get more growth abroad rather than have a begger thy neighbor policy?

And, two, if oil came down significantly to Rimmer's 18, what would that do to the external balance?

Well, if oil did in fact come down, on my calculations, we move to a deficit between one-half and 1 percent of GNP. And the remaining half is the $50 billion he is talking of as comfortable.

So I have a scenario where even with foreign growth not picking up strongly relative to ours, in the next 2 years, the deficit goes down very significantly. And I see dollar depreciation very inflationary for the U.S. economy unless oil comes down to offset it.

And I see a world strategy of creating growth much more positive than to say we're going to depreciate and you're going to look at how you get employed.

I see that last strategy as very risky because I think the Germans are more stubborn than Dick Cooper gives them credit for. Now he has lived there. I have lived there. We know they're stubborn. But I don't really see them change their fiscal policy.

They consider it a natural achievement. Having reduced the deficits, what will they do? They might just sit there.

And if they sit there, all of Europe would have really a lot of problems.

That's why I'm saying why don't we very aggressively look for lower world interest rates. Not by pushing down the dollar, but by breaking everybody's arm to cut rates.

We can afford it. There is no inflation risk. And it would solve every problem in the world that we know. Budget deficits immediately will go down because debt service will come down here, in Germany, and in Japan.

In Germany, when the deficit comes down, they can even afford to give tax cuts without having a deterioration in the fiscal position. And in LDC's the Baker plan does nothing. Lower interest rates will do miracles.

Every percentage point reduction in the interest rate reduces Mexico's debt service by 1 percent of GNP. Fantastic impact.

Our farm problems will look better. Wherever you look, there is happiness from lower world interest rates, and there is no cost to it. The only obstacle is stubborn Germany. So why don't we concentrate on that and say, well, if we are big, surely, we must get those guys to be able to cut interest rates in a circumstance where, in Germany, prices now are falling.

When they say inflation, we show them your prices are actually falling. And with falling oil prices, you're going to have deflation, you have to start worrying.

And I would think that there must be consensus among us on that. And that is worth saying loud because it's something really positive as a strategy.

If we can't achieve that, that says target zones are totally impossible.

Sorry to take so long.

Mr. KRUGMAN. Let me—I think I am going to part——

Representative HAMILTON. Let me just interrupt to say that your comments raised in my mind this whole question of coordination of economic problems.

Mr. de Vries wants the German and Japanese to speed up things. You want them to lower interest rates.

Mr. DE VRIES. That is the same thing.

Representative HAMILTON. That is the same thing. They are not going to lower interest rates, or they apparently aren't going to lower interest rates.

When we talk about coordination of economic problems here, are we chasing something that we can achieve?

Mr. KRUGMAN. OK. I am going to try and stress these areas. I just want to take a short detour.

There is one thing that we agree on around this table so much that no one has even mentioned it. No one has even mentioned in discussing causes of the trade deficit, sources of the problem, unfair foreign trade practices.

I think that there must be unanimous consensus here that the contribution of unfair foreign trade practices to the growth in the deficit is zero—plus or minus zero. And so I think that is an important thing to stress, given Senator D'Amato's remarks at the beginning.

There is also, I think, a consensus that such villainy as there is is not solely in the United States and that the Germans should stop being crazy.

Representative HAMILTON. Stop being what?

Mr. KRUGMAN. Stop being crazy, that the Germans have plenty of room to lower interest rates and that if they did, that we could at least to some extent follow them down, as could the Japanese, and that this would be a desirable thing.

I think the disagreement is really about whether a unified world expansion, a coordinated monetary expansion, which is what Rudi is advocating, is enough.

How do you know that we have adjusted enough in terms of our trade position?

Rudi tells us that the current level of the dollar will lead to a fall in the deficit to only 1 percent of GNP, and he says that is enough.

First of all, I don't believe that 1 percent. But even granting that, we have to recognize first of all that that is by historical standards a very large deficit for the United States. If in 1978 you had said by 1988 the United States will have a current account deficit of 1 percent of GNP, people would have said that is a very large number. Perhaps that is wrong, but still that is the way we do react.

Now one of the most important reasons we care about these numbers or one of the most important reasons we care about competitiveness is the issue that Dick Cooper raised, which is the protectionist pressure in the United States.

I don't think the number matters so much there as the perception by U.S. firms that they are once again on a more or less level field in terms of relative costs. I don't believe that the current level of the dollar is yet low enough to do that. It buys us some relief from the protectionist pressure, but it doesn't really give us enough relief.

And so whatever the number, whether Rudi is right at 1 percent or I am right saying that we would have a 1.5- to 2-percent current account deficit after 2 years at this exchange rate, is not so important as the fact that from the point of view of the critical political balance in the United States the dollar has not fallen far enough.

But, yes, you have two definite areas of agreement—no, emphasis on foreign trade policies; yes, emphasis on German policy as being irresponsible.

Mr. Cooper. And I would add, third, there is agreement on the point that Bill Branson emphasized, which is that there is an intimate relation between the fiscal deficit in the United States and the trade deficit. From national savings-investment balance, the only way to assure a smaller U.S. current account deficit is to correct the imbalance between national saving—that is private saving plus the budget deficit—and domestic investment.

We do not have much of a grip on private savings. We have fiddled with this and that feature of our tax system, but the fact is there is a lot of resistance in private savings to manipulation by policy.

The main policy lever we have on that balance is through the Federal budget, and if we want to see a zero current account balance, by 1990, let us say, it is worth noting that since World War I we have run a current account surplus of about half a percent of GNP, but if we want to see zero or go to Rimmer's $50 billion, we are not going to see that without a major reduction in the fiscal imbalance.

I think there is general agreement on that.

Representative Hamilton. As a policy issue for the U.S. Government, how do you get the Germans to get the interest rates down? What do you do specifically?

Mr. de Vries. The economic forces are at work right now. The dollar is declining in response to the oil price collapse, which benefits Europe more than the United States.

Representative Hamilton. Do you think the events, the economic events will drive them to that position?

Mr. de Vries. Yes. The markets will do that. There is not much we can do.

Representative Hamilton. There is not much we can do about it.

Mr. de Vries. Absolutely. If politicians don't want to do it, the markets will eventually do it for them.

Mr. Dornbusch. That is a system we don't want.

Mr. de Vries. No, we don't want that. It is very crude, but eventually markets will do it.

Representative Hamilton. Your instruction to the Secretary of the Treasury then would be to just sit back and relax and don't do anything?

Mr. de Vries. No. My preference is, as I have said, a much more activist G–5 or G–7.

Representative Hamilton. What does that mean?

Mr. de Vries. Well, I would use a credible threat. As you know, I don't agree with a complete surcharge as Bill Branson suggests, but on the other hand, I think the credible protectionist threat has already produced quite a lot.

I think the success of the G–5 meeting at the Plaza was due to an environment in which foreigners were getting very worried about U.S. protectionism. In the fall when some of those foreigners came to Washington, they said, thinking the protectionist threat had disappeared, the dollar had fallen far enough.

I do not believe that, but that is the link they made.

Representative HAMILTON. Well, when you say in your statement, as you just did, and I think you wrote in your prepared statement, that you have to use G-5 or G-7, or whatever it is, more actively——

Mr. DE VRIES. Right.

Representative HAMILTON [continuing]. What do you mean by that?

Mr. DE VRIES. Well, the G-5 stands for the major five OECD countries, and the G-7 includes Canada and Italy. I mean they should meet together and seriously discuss the world environment and policies necessary to achieve higher noninflationary growth in the world.

Representative HAMILTON. So you try to persuade the Germans to bring the interest rate down?

Mr. DE VRIES. Right. You come up with these numbers and models, and say, if we don't do this that will happen, and we will all be worse off.

Representative HAMILTON. Should they make a statement as the G-5 or G-7 group that we are going—we have to lower the——

Mr. DE VRIES. I think Mr. Volcker has repeatedly testified in this House to the strong desirability that the Europeans and the Japanese stimulate their economies. I don't think there is a single statement from Paul Volcker on the subject in which he hasn't mentioned it.

Representative HAMILTON. And that is OK with you?

Mr. DE VRIES. Of course.

Representative HAMILTON. That is the right thing to do?

Mr. DE VRIES. Of course. I think——

Representative HAMILTON. Should it be the policy of the U.S. Government now then to lower the value of the dollar and we ought to talk about that publicly?

Mr. DE VRIES. No, I think that is what the markets are doing right now, and the dollar will sink somewhat further.

The reason I presented those basically illustrative cases is to drive home the point there are different ways of reducing the current account deficit. One person would say let's do it all through the dollar while another would say that is not the way we want it.

Precisely how far the dollar has to decline as part of a solution is a model problem that can be sorted out by the technician.

What these scenarios bring out is the much greater benefit at this stage of more growth abroad than of dollar depreciation.

Mr. COOPER. Let me make a remark.

Representative HAMILTON. Go ahead, Mr. Cooper.

Mr. COOPER. I share Rimmer's and Rudi's objective completely, but the trouble is and I detect it lying behind your questions, it is not instrumental.

That is, Rudi says bring world interest rates down. You have to ask how do we do that exactly. Interest rates are not determined by government announcements. I would suggest it involves somewhat more expansionary monetary policy, which I thought was being rejected.

Now, on the question of the expansion abroad, I believe and have so argued now for, I guess, 4 years, that both Germany and Japan have been pursuing fiscal policies which are undesirable from a global point of view, whatever their merits may be domestically.

I am impressed by how exclusively domestic the debate on fiscal policy is in both of those countries. They are completely tied up in their own affairs—not unlike the United States in this regard. But what is striking is that these economies, both of which are more open than the United States, are completely absorbed in their domestic preoccupations in determining fiscal policy.

So I am more pessimistic than Rudi Dornbusch and Rimmer de Vries are about persuading these countries to adopt a more stimulative fiscal policy. It would be desirable if they could be persuaded, and it is worth noting that each of them has moved slightly in that direction. But they have not done much.

Therefore, I think that some kind of forcing action is needed, and what will get their attention is a sharp loss of export competitiveness of their own products.

Last year, 1985, 3 years into world economic recovery, 60 percent of new orders in Germany were foreign in origin. That is, domestic demand in Germany was very weak, and they have been relying for their economic activity mainly on export growth. For a country that is the third biggest country in the world, that is just unacceptable from a global——

Representative HAMILTON. And a more stimulative U.S. monetary policy would hurt their competitiveness?

Mr. COOPER. Well, a weaker dollar would hurt their competitiveness, and then we can talk about how best to bring about a weaker dollar.

I am perhaps overly impressed, because I was a participant, by the parallelism to 1977, where we made a valiant attempt to persuade both Germany and Japan to adopt somewhat more stimulative policy because in many ways the situation was similar to that today. But we failed to persuade them in 1977.

The United States went ahead alone. The dollar did depreciate, and that got their attention. The pattern of demand began to change in both of those countries away from foreign orders, and by July 1978 they were prepared to agree to fiscal stimulation.

It is far better to go the route of persuasion. But Rimmer and I were both in a meeting in Europe 2 weeks ago. We haven't had a chance to compare notes, but I was impressed by the enormous complacency of the German officials at that meeting. I have rarely seen such stand pattism. I don't argue the undesirability of persuasion, but I doubt it will work. Objective events are needed to get their attention, and therefore that is what we should be looking for.

Representative HAMILTON. Mr. de Vries, then Mr. Krugman.

Mr. DE VRIES. Yes, I don't disagree with all this, Dick, about practically needing a political change there and a change of personalities. They made a fetish out of these issues in Germany, and there is a good deal of nationalism involved as well.

I think Dick is correct in that the further decline of the dollar will force Europe and Japan to recognize they have lived on foreign demand to a very large extent with limited domestic demand growth, and if foreign demand falls away, they will be hurt. The Japanese got very worried about it at Christmas. As the dollar declined they saw their economy falling out of bed because of their tight fiscal and montetary policies. That is why they changed their discount rate, and they will have to do more. The Germans haven't gotten to that point yet.

Now I want to come back to the oil market. The decline in oil prices is an economic plus, raising Japanese and European growth by a half three-quarters of a percentage point. So what they didn't want to do so far, to some extent oil markets are doing. It is a one-shot affair, not the solution as it helps them only for 16 to 18 months.

The oil price decline also helps lower inflation. Our projections show that Germany will have zero inflation this year. And probably negative inflation at the producer price level.

So the oil price is bringing the dollar down by reducing their inflation relative to ours. We don't know how to get the dollar down, but I think the lower oil price is doing it.

I have a feeling with the lower dollar there will be some changes in policy this year and next. We have to work at it, and I would say there might be a need for some credible threats in the G-5 context.

John Connally is still one of my heroes, I will say, maybe not yours. [Laughter.]

I think we need some table pounding once in a while.

Representative HAMILTON. Mr. Krugman, then Mr. Dornbusch.

Mr. KRUGMAN. OK. We have two routes, the route of incentives, carrots but mostly sticks, and the route of persuasion.

I think we have an agreement that the best thing, the best way to force the Germans to at least think hard about whether they want to expand is to get the dollar down, but for the reasons I was arguing, I don't think a policy of trying to get the dollar down in advance of getting our own fiscal house in order is a good idea. I think that is too risky a strategy.

But if we can do that, if we really are going to have these sharp deficit reductions, then of course that should come along with the compensating monetary expansion, and that will get the dollar down, and that will get the Germans' attention and will help.

That is one line. But it also does help to talk, and I think the best thing that we could do is to try to get Congress angry at the Germans.

In the past several years, we have had a situation where Congress is always angry at the Japanese, and that actually allows the administration to pursue what in many respects is an amazingly successful policy. This strategy involves going to the Japanese and saying give us concessions or I don't know what those guys on the Hill will do and going to the Hill and saying just hold off a little bit, we will get something out of the Japanese. And in fact we have received a great deal.

What we really need to do is shift that spotlight onto Germany, recognize that in fact at this moment Germany rather than Japan is the foreign country who is pursuing policies that are causing problems for the world economy.

And I don't know exactly how one does that, but I think it can be done to at least some extent.

Mr. DORNBUSCH. I would like to follow up exactly on the same line you asked earlier about the leadership question.

And it is true that Germany is on a par in leadership with the United States because all of Europe is coordinated around the German policies through the EMS. Every one is a weak country except Germany, that is strong, the adjustment falls on the weak ones. Everybody would love to cut interest rates, but nobody can unless Germany does.

And Germany says, no, we don't need it, so that she is keeping interest rates high.

What this requires then in such an atmosphere of complacency and policy directed toward German objectives primarily is to do exactly what Paul says: turn the spotlight on the policymakers and say this is asocial behavior.

And if we make the German monetary and fiscal policies an international issue, then at least one other side of it can be seen.

Europe will find that extremely popular. The LDC's will find it extremely popular, and I think more has to be said.

We have, I think, made a mistake pushing fiscal expansion in Europe. That is desirable, but that is not something that European politicians want to be seen doing before next year's election.

That is why I say the interest rate cut is something that is much more possible in the face of the foreign crisis. Real interest rates have been rising.

And I think there is no obstacle to making that a big public issue for Volcker, for Baker, for Congress, as everyone on every occasion says that if we got lower interest rates in Europe, then we also might be able to have them, and then everybody would be better off.

Representative HAMILTON. Mr. Branson.

Mr. BRANSON. Well, I think that there's agreement here that it would be nice if there were an expansion in Europe. I would be a little reluctant to say that that should be the extent of U.S. policy to suggest to the Europeans that they do something. And I think that we ought to be thinking about macropolicy, at least conditional, on the possibility that the Europeans are not so accommodating. And in that case, one comes back to the—to the two alternatives which—one of which is in Rimmer de Vries' dollar collapse scenario.

He had dismissed that as being distasteful or not preferable, but it seems to be the most likely, in the absence of substantial further fiscal change in the United States.

The tone here has been kind of—should the United States get the dollar down? I think what is happening is, the dollar is falling. The issue isn't should U.S. policy be to get the dollar down. The dollar is falling now. There might be an issue should the U.S. policy be to resist the fall on the dollar.

Representative HAMILTON. Is the dollar in a danger zone, as the Chairman of the Fed said yesterday?

Mr. BRANSON. I don't think so. I think it's falling along Rimmer's dollar collapse scenario.

Representative HAMILTON. Collapse?

Mr. BRANSON. That's what he's labeled it. I would have said the——

Representative HAMILTON. That's what he labled how it falls.

Mr. BRANSON. Yes. I mean, eventually, if the U.S. budget deficit situation is not corrected, then the U.S. private sector is going to have to finance that budget, and the only way that can be done is by reducing domestic investment and getting the current account balance roughly back to zero. I take it that that is—that is what is behind Rimmer's dollar case II scenario, is not much action on the budget, rising interest rates, falling dollar, correction of the current account through the market pushing the dollar down, as a consequence of getting overloaded with dollar assets in their portfolios.

Representative HAMILTON. You know, one of the things that struck me about your observations this morning is, you don't seem to be too worried about a new exchange rate system, and that makes me wonder why the President, in the State of the Union Address, directs the Secretary of the Treasury to examine the possibility of an international conference on the exchange rate system.

Was he just off the mark there? I mean, is that something we ought to do? If you are the Secretary of the Treasury, how are you going to respond to—Mr. President, how are you going to respond?

Mr. DE VRIES. I think it is very desirable to study these things. As students of economics, this is one of the main things we keep studying. Even if the result is only that we agree on the need for policy coordination we will have accomplished something.

I don't think the President advocated a new exchange rate system, he just said, let's study this thing, review it some more.

Representative HAMILTON. But Presidents don't call for studies without some reasons for it, you know. If the real question is policy coordination, why didn't he call for a study of policy coordination?

Mr. BRANSON. He already said that.

Mr. DE VRIES. That is what I call putting the cart before the horse. I have a feeling there is some wishful thinking. The example of the EMS, the European Monetary System, is worth studying. By just setting up the monetary system, would you have better policy coordination? What would you really get from just agreeing on exchange rate zones and divergence indicators? I think the answer is "nothing."

I think it is wishful thinking that just by setting zones, you will get the right coordination.

In the EMS there has been no coordination; everybody has been following the tune of the Germans. Germany has dominated economic policy in the rest of Europe.

Representative HAMILTON. None of you support the target zones. Do you support them?

Mr. DE VRIES. I would support them if I were convinced we would get more policy coordination by just setting zones. And that is what we are after.

Representative HAMILTON. Is the purpose of the target zone idea to try to get more coordination?

Mr. DE VRIES. Well, yes, otherwise, you would have to reset your zones every day.

Representative HAMILTON. Yes. All right. OK. Mr. Branson.

Mr. BRANSON. Well, I think that the target zone idea clearly would need to have some proviso about things like major shifts in budgets, because then the location of the zone would have to change. The target zone idea presumes that those zones remain reasonably stable, and then the monetary policy can be coordinated to keep exchange rates within the zones, but if you get major shifts in fiscal policy, then you have to have some way to change where the zone is, in order for monetary policy to be able to continue to be effective within a zone.

So you have to have an arrangement as they happen within the EMS for occasional realignment of the entire system.

Representative HAMILTON. What happens if a country gets outside the zone?

Mr. BRANSON. Well, then you realign the band.

Representative HAMILTON. You redraw the zone.

Mr. BRANSON. Oh, sure. And I think, a little bit contrary to what Rimmer was saying, the experience within the EMS has been positive, in the sense that countries feel obliged to explain their policy to each other and that leads both to an improvement and policymaking and to an improvement in communication. But I would oppose the idea of a conference. It seems to me that an international conference with many, many players would be completely unproductive, and the idea of a new Bretton Woods as the image for this conference is completely misleading, because the original Bretton Woods only had two countries participating in it: the United States and the United Kingdom.

Representative HAMILTON. Do any of you support the idea of an international conference?

Mr. COOPER. The idea of a conference, a la Bretton Woods, is completely premature. There were many countries at the Bretton Woods conference, but the big difference was that——

Representative HAMILTON. How many?

Mr. COOPER. Over 40, I think.

Representative HAMILTON. There were a lot of them?

Mr. COOPER. Yes.

But the big difference was that the conference was called, basically, to amend and endorse a plan that was put before them which everyone had a chance to study.

Representative HAMILTON. Drawn up by whom?

Mr. COOPER. Drawn up basically by the British and the Americans. The scheme was negotiated beforehand between the British and the Americans.

Mr. BRANSON. That is what I meant by the conference was between two countries.

Mr. COOPER. A big conference can be used to either launch an idea—but then it seems to me you do want something more private than governments—or to formalize and agree on an idea. An official conference at this stage is vastly premature. We need much more study, a lot of it behind the scenes, officials looking at various alternatives seriously. The interaction that Rimmer has referred to between exchange rate commitments and policy coordination is not a one-way interaction. It does go both ways. We have examples, both under Bretton Woods and the EMS, where policy has adjusted to the exchange rate commitment, but we also have examples going the other way, where the exchange rate commitment has been adjusted to the policy differences. So the relationship between policy and exchange rates is rather subtle.

All of those things need to be looked at, and we shouldn't think of a conference in the fashion of Bretton Woods, until we have something that is in the ballpark of being agreeable to the major players. We are just nowhere close to that now.

Representative HAMILTON. OK.

Mr. DORNBUSCH. I wanted to make three points on the target zone and the conference.

The first is the role of fiscal policy, that big shift that doesn't get mentioned that is in there. If we had a target zone, and we have a big shift in policy, then we would say, well, the real exchange rate must appreciate. But it is very hard to see the Secretary of the Treasury coming back from London and saying, I have agreed to reduce the competitiveness of U.S. manufacturing by 30 percent, to accommodate our reckless deficits.

You can't do it, but if you don't do it, then monetary policy has to make the target zone stick, and that means you print the money to finance the deficit, you get the worst of all.

The second is, EMS, where countries explain to each other their policies, and that isn't how it works. Italy goes generally to explain their policy, but it is not a two-way street. You need a very homogeneous group and leadership, in order to run a fixed exchange rate system, and the weak ones have to adjust, and the strong sets the tone.

If the United States gets into an arrangement like that, we want to be sure that we set the tone.

And the last is capital mobility. And the Bretton Woods systems was a system where nobody thought of free international flows of capital. And now very few would say that you should restrict international capital as the basic operating mechanism for an exchange rate system.

Representative HAMILTON. Mr. Krugman.

Mr. KRUGMAN. What I wanted to interject there was a comment on the EMS, which we must realize consists of Germany, two nominally independent provinces of Germany, and two large countries, France and Italy. The two nominally independent provinces are the Netherlands and Belgium. The two large countries have capital controls. It is not a system that is having to cope with the kind of free large movements of capital that a worldwide fixed exchange rate system would have to cope with.

If we introduced capital controls and arranged that everybody but the core country, the United States, had them, then we might be able to do that. But EMS is not a very valid lesson for what might happen worldwide.

I just want to add that the answer to the question of why we are talking about an international monetary conference and a new system is, of course, we are looking for—I don't know whether you want to call it a magic bullet, a pill—a sugar-coated pill, which we painlessly swallow, which makes the difficulties go away, a free lunch. Everyone would like to believe that by some change in institutions, which means essentially a change in the way we describe what we are doing, that we can get all the answers, we can avoid these problems.

There is more to that than I would have thought 2 years ago. The exchange rates have been going wild for no apparent reason, at times, as they did from mid-1984 to early 1985, and against those kinds of seemingly pointless exchange rate bubbles, seemingly content-less assistance can also make a difference.

Representative HAMILTON. Do you see any value at all in the summit meetings as a device for getting the leaders to focus on the international economic policy coordination rather than domestic economics, which all of you have said or several of you have said tends to override international aspects?

Are the summits worthwhile?

Mr. KRUGMAN. I think that the cost is substantial. Expectations are raised, and intellectual resources are diverted from thinking about the real issues, into what some people in this government have called nuancing. I think these costs outweigh any possible benefits.

Representative HAMILTON. Mr. de Vries.

Mr. DE VRIES. Yes, I think a G-5——

Representative HAMILTON. Is a better forum.

Mr. DE VRIES. I think it is a smaller forum, more informal, can be arranged more quickly. I think the summit meetings are mostly ceremonial affairs, and the leaders want to smile and say that everything is well in the world, but don't want to discuss real economic problems.

No, I'd rather go with G-5.

Mr. COOPER. I do not agree with the consensus on this issue. I think that the summit meetings are useful for two reasons, although I agree that they have this ceremonial, public relations role, and I would also have to say that the summit is not going to be any more useful than its major participants want it to be. If the participants don't want it to be useful, then it won't be. As an institution, however, it can be, and I would argue has been, useful in two respects.

One is that there really is a difference between the political leaders of the major democracies coming together and their finance ministers coming together. Prime Ministers and Presidents have shared concerns and shared experiences and constraints on their room for maneuver, which Finance Ministers do not have in the same way. It is useful to have a forum in which these folks can share their experiences and their concerns directly.

Second, it is worth keeping in mind that most Prime Ministers and Presidents—Schmidt and Giscard d'Estaing were exceptions, because they had been former Finance Ministers—do not take a deep interest in economic policy. That is a fact of life. The process of preparing for a summit and the prospect of having to explain one's national policies before one's peers, in the only sense in which Presidents and Prime Ministers can have peers, is potentially, and in fact on occasion has been, a useful discipline.

First, the briefing brings the head of government up to speed on what his own economic policy is. It gives the economic officials a chance to get at him.

And second, having to explain the policies has the potential for exerting some discipline. So I am a qualified supporter of the economic summits.

Representative HAMILTON. Well, I think it is also true that Presidents have a very intensive economic education, but that economic education is domestic. Their whole experience is domestic economics and very little of it is international economics.

Did somebody else want to talk?

All right. We're going to wrap it up here.

Mr. DE VRIES. I would presume the heads of state who attend summits stress their usefulness, but are they useful?

Mr. COOPER. It is not a decisionmaking body. One does not look at it as a place to coordinate policies in any detail.

Representative HAMILTON. All right. I am going to ask each of you to make any concluding comments you'd like to make, but there is one thing—there are several things we haven't got to, that I wanted to, but I would like you to comment on how you feel, specifically, about the question of intervention on exchange rates.

I think you, Mr. Cooper, said that you favored more vigorous intervention, but I am not sure the others commented about it.

So let's wrap it up. I will let each one of you make any concluding observations you'd like to make, and if you want to hit upon that, I would appreciate it.

Does anybody want to start off, to conclude here?

Mr. DE VRIES. Well, I think you have to have a very pragmatic approach toward intervention; don't show all your cards, in the markets, create uncertainty. I do not think it is practical to intervene only when the President is shot, and then only with a few pennies. There may be times, indeed, when intervention can be very effective; however, in the last 6 months, the open mouth policy has been a lot more effective than the open market policy.

Mr. COOPER. I have already spoken to the question of intervention, and I agree with what Rimmer has said, and I think that now is the time we, the United States, might want to do some intervention, not on a massive scale, but as a signaling device.

Having said that, I would like to use my wind-up remarks to address the question of coordination of policy, because Rudi Dornbusch said earlier that you need to coordinate all kinds of policy if you are going to limit the movement of exchange rates. There is possibly a semantic difficulty here around the word "coordination." By "coordination," I think of something active. One consciously and deliberately coordinates.

Another kind of coordination, which Rimmer alluded to earlier, and that is coordination forced by external circumstances and in particular forced by the market. That distinction, in my judgment, is crucial, when one thinks about monetary and fiscal policy under a regime of either one currency or stable exchange rates.

Monetary policy has to be coordinated, in the sense in which I use it. It is devoted to maintaining the exchange rate, and that involves deliberate actions. In my view, and here I may differ from my colleagues, fiscal policy does not have to be coordinated in that sense. Fiscal policy can be left free to the individual nations.

Now what does "free" mean? It doesn't mean that they have a completely uninhibited hand. They cannot finance their budget deficits at the central bank. They have to go to the financial market to borrow. This necessity puts contraints on their fiscal freedom. In that respect, it's something of a mistake to ask the question, suppose we had had fiscal policy the last 5 years under a regime of fixed exchange rates? But we wouldn't have had the fiscal policy of the last 5 years under a regime of fixed exchange rates.

An example we have of that is France, which was forced to decide whether to withdraw from the EMS or alter its fiscal policy. It could have left the EMS. That was an option, but it chose instead to alter its fiscal policy.

Think of the United States of America. We after all have a currency union. One currency for all the States. Massachusetts uses the same currency as Indiana and as California. The fiscal policies of States in some cases are limited by their own constitutions, but in principle they are free; there is no formal mechanism to coordinate the fiscal policies of States.

They are, however, limited by their ability to borrow in the market. A world of high capital mobility both creates the possibility of borrowing in the market—rather than at a central bank—but also imposes a constraint.

So I think that one has to be careful in laying down the criteria. What actuallyhas to be done as a conscious act is to coordinate monetary policy, but I would argue that fiscal policy does not have to be consciously coordinated under a system of fixed exchange rates, although it will be influenced by the economic environment.

Representative HAMILTON. Anything else?

Mr. KRUGMAN. Let me make three summary remarks, the last of which is about intervention.

The first one is, I think we have a consensus that the fundamental sources of the mess in the world economy don't lie in the exchange system but lie in incorrect domestic policies, particularly U.S. fiscal policy, but with a fair amount of help from our friends, that changing the exchange rate system wouldn't change that.

I think we also have a consensus that floating rates have by and large made the mess less bad than they might have been under other systems, unless you think the fundamentals will change as Dick Cooper is arguing. By and large, if you take as given those fundamental sources of the mess, the mess has been somewhat minimized by floating rates.

Third, though, floating rates don't work perfectly, in the sense that you can't say that as long as we have domestic policies right, the markets will also get it right.

I don't see how you can still say that after the experience of the last 2 years, which gives us a case for sometimes trying—even if we haven't got domestic policies fully under control or even more so, if we do—trying to lean against the wind and trying to burst those speculative bubbles, and yes; intervening in the exchange markets, not so much because we think that is a permanent solution to anything, but that it can serve as—I have used this expression before—as a slap in the face, when the markets are going wild, force the markets to think about what they are doing.

Mr. BRANSON. I think I'd agree with Paul's characterization of what's generated the mess and the role of exchange rates in it. I think that there's probably a consensus here that it would be very good to have a European expansion that probably, in addition, but certainly failing that, it would be important to do something on the fiscal policy side, the United States, with a complementary change in monetary policy.

I think, third, if that is not done, the dollar is going to be devalued anyway by the market, because of resistance on investors' side, and I think—I guess I agree with Rimmer that one way to get action in Europe would be to have a credible threat. Protectionism, in a strange way, serves, as long as it doesn't have to be used too often.

Mr. DORNBUSCH. I would like to make two remarks, but first I think there is agreement here that if you wanted stable exchange rates, exchange rates that don't move, then you have to do quite extraordinary things to the market economies that are linked by those exchange rates. In particular, you couldn't go in opposite directions ever, because then you can't have the stable rates. If you don't worry about the rates, you can do anything you want, and having flexible rates, makes that particularly easy, and that's what was done the last 5 years, but then you must not complain.

It is the policies that do it, not the exchange rate system, and that is where we then, in the end, agree on coordination. If you promise not to complain about the exchange rate movements, you don't have to coordinate. If you want to complain, then you can't go in opposite directions.

The second point, there is a lot of agreement here on, is that we are concerned about how the exchange rate goes back to the domestic economy, on the inflation side and on the employment side, and when we want to move our exchange rate to wipe out our deficit, we'll always have to ask what happens abroad.

We can take two views, that they better look after themselves to be able to live with our gaining competitiveness, or we could propose other particularly nifty moves that would make everybody better off. And I think we all agree on the interest rate, and once that has happened, we can ask whether they also should expand their budgets, and with the interest rates lower, they can afford it.

Mr. DE VRIES. Mr. Chairman, you have asked about the desirability of a conference, and we all were kind of negative on that.

I wish our academic colleagues would do a study of international monetary policy and its links with budget policy. They are obviously connected, and I think this would be very, very useful.

Mr. BRANSON. Morgan Guaranty will provide the grant? [Laughter.]

Mr. DE VRIES. We will give you a summer position. [Laughter.]

Representative HAMILTON. All right, gentlemen. Thank you very much.

We've had a good discussion this morning, and I appreciate your contributions to it.

The subcommittee stands adjourned.

[Whereupon, at 12:07 p.m., the committee adjourned, subject to the call of the Chair.]

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